PROPOSALS FOR A MUTUAL FUND LAW FOR CANADA

vol. 1
1974

Canada
Dept. of

Consumer and Corporate Affairs
Consommation et Corporations

Available by mail from Information Canada, Ottawa,
and at the following Information Canada bookshops:

HALIFAX
1687 Barrington Street

MONTREAL
640 St. Catherine Street West

OTTAWA
171 Slater Street

TORONTO
221 Yonge Street

WINNIPEG
393 Portage Avenue

VANCOUVER
800 Granville Street

or through your bookseller

Price $5.00 Catalogue No RG23-19/1974-1 (2 Vol)

Information Canada
Ottawa, 1974

PROPOSALS FOR A CANADA MUTUAL FUNDS LAW

VOLUME I
COMMENTARY

BY

JAMES C. BAILLIE WARREN M.H. GROVER

TABLE OF CONTENTS

PREFACE

When we were requested by the Department of Consumer and Corporate Affairs to prepare this report, only one guideline was given to us. We were to endeavour to arrive at a draft statute that would reflect the best of current knowledge and practice in the area and would also reflect the distinctive needs of the Canadian market and economy. In doing so, we were to draw on the recommendations made in the 1969 report of the federal-provincial Canadian Committee on Mutual Funds and Investment Contracts, often called the Mutual Fund Report, but we were also to take into account legislative experience and developments in other countries. As indicated in the Introduction that follows, both the United States and the Organization for Economic Cooperation and Development have recently given much consideration to the regulation of the mutual fund industry and other countries also have detailed regulatory patterns. With so much upon which to draw and such a general directive, we have found that the difficulty of our task was matched only by the stimulation we derived from it. We hope that the results will lead to useful discussion in Canada and contribute to the development of Canadian legislation and regulation affecting mutual funds.

The format of this report largely parallels that of *Proposals for a New Business Corporations Law for Canada,* published in 1971, with draft statute and a commentary. This format has put us to the healthy discipline of having to think through our ideas in detail. This was of particular value since on a number of important questions we adopted the recommendations of the Mutual Fund Report that differ from legislation in force elsewhere so that from a drafting standpoint it was necessary to cut from whole cloth. Where feasible we have drawn on the experience of others and readers will find that many sections of the draft statute are copied from or influenced by legislation in effect or proposed in other jurisdictions. We have also drawn upon the experience of the provincial securities commissions in Canada, as reflected in their published policy statements and in Ontario's recently proposed Bill 154 and those of the briefs commenting on that Bill to which we had access.

We were most fortunate to have the services of George Cummins of the Department of Consumer and Corporate Affairs made available to us. He did extensive work in digesting the voluminous source material available, cross referencing suggested standards under various proposals and generally keeping the project organized.

John Howard and Phil Anisman of the Department of Consumer and Corporate Affairs contributed many perceptive suggestions. From the Department of Justice, Messrs. Ryan and Pepper helped to clarify principles of statutory drafting. Peter Hogg of the faculty of the Osgoode Hall Law School of York University made a significant contribution through his advice on constitutional questions and the preparation of a memorandum which forms part of this report and he, together with Rick Salsberg of Tory, Tory, DesLauriers & Binnington, reviewed the report as a whole and made a number of helpful comments.

Nothing can be produced without good secretarial help and we have been most fortunate in this regard. Barbara Persaud has shown more patience, skill and devotion than we could have reasonably expected.

In the preparation of the report we have drawn without reservation upon ideas and research contributed by the persons mentioned above and many other gifted people. We are grateful to them all, since the preparation of the report would have been virtually impossible without them. The selection and synthesis of the ideas in the report has, however, been our sole responsibility.

Finally, we wish to express our appreciation to our respective colleagues, on the faculty of Osgoode Hall Law School of York University and in the firm of Tory, Tory, DesLauriers & Binnington, for their patience and forbearance while we were engaged in the preparation of this report.

November 1, 1973

Warren M.H. Grover
James C. Baillie

REFERENCES

Bill 154	Ontario Bill 154, 2nd Session, 29th Legislature, Entitled The Securities Act, 1972, First Reading, June 1, 1972.
Investment Company Act	United States Investment Company Act of 1940, 54 Stat. 79, as amended by Investment Company Amendments Act of 1970.
Institutional Investor Study	Report of the Securities and Exchange Commission, Washington, 1971.
Kimber Report	Report of the Attorney General's Committee on Securities Legislation in Ontario, 1965.
Mutual Fund Report	Report of the Canadian Committee on Mutual Funds and Investment Contracts, 1969.
OECD Proposals	Standard Rules for the Operation of Institutions for Collective Investment in Securities, Paris, 1972.
Proposed Canada Business Corporations Act	House of Commons Bill C-213, First Session 29th Parliament, First Reading, July 18, 1973.
Public Policy Report	Report of the Securities and Exchange Commission of the Public Policy Implications of Investment Company Growth, Washington, 1966.

INTRODUCTION

This report proposes the adoption of significant new legislation. It seems appropriate in the introduction to inquire what need the legislation is designed to meet and to review some of the approaches taken in arriving at proposals to meet that need. The IOS scandal, where Canadian organized mutual funds operating virtually unregulated in the overseas markets declined catastrophically in value and did great damage to Canada's reputation with foreign investors, would alone be sufficient to indicate a need for new federal legislation in Canada. But the need would exist apart from this evidence.

Mutual funds are the only important class of Canadian financial intermediaries not regulated by a specific federal statute. Banks, life insurance companies, federally incorporated loan and trust companies and closed-end investment companies are subject to statutes which differ in detail but reflect a consistent philosophy. This is that intermediaries which handle public funds in liquid form require more detailed regulation than most other types of business. This regulation protects public investors. It also assists reputable members of the industries involved by preventing damage to the reputation of an entire industry through the actions of an unethical minority. Legislation for this purpose is appropriately adopted at the federal level particularly where the financial intermediaries concerned operate regularly in the interprovincial and international markets—which is the case with mutual funds.

Canadian mutual funds are currently regulated at the federal level only through general corporate and tax legislation and at the provincial level through general corporate and securities legislation. Yet all of the considerations which support detailed regulation of other financial intermediaries are of at least equal relevance to mutual funds. Certain distinctive features of the industry strengthen the case supporting legislation tailored for it. Mutual funds are the only major intermediary oriented almost exclusively to equity investments. Their distribution arrangements are designed to enable them to provide investment opportunities on an economic basis to persons with very few dollars to invest and who might otherwise be unable to participate in the equity markets. Their shares are sold in large part through the use of techniques designed to bring them to the attention of such persons. All of these characteristics underscore the scope of the abuses that could be perpetrated by unethical participants in the industry.

International consensus is emerging as to the desirability of mutual fund regulation. The OECD Proposals, referred to frequently in this report, and contributed to by some eleven nations, are excellent evidence of this. England and the United States have had detailed regulatory patterns for many years. There is consensus in the United States that the Investment Company Act of 1940 has contributed substantially to the success of the mutual fund industry in that country and it is reasonable to assume that the same may be said of regulatory patterns applied in other countries. We hope and anticipate that adoption of legislation such as is proposed in this report would have similar results in Canada.

In summary, it seems clear that the mutual fund industry should be regulated under legislation tailored for the industry. This legislation should deal with the potential problems which mutual funds have in common with other financial intermediaries and should also pay heed to the distinctive characteristics of the industry. Its objective should be to require industry-wide adherence to a high standard of conduct and thereby to protect investors and to contribute to the maintenance of the industry's reputation. Because the mutual fund form of organization is evolving and dynamic, care should be taken that the legislation provides

maximum flexibility for expansion and experimentation, constrained only as necessary to ensure that regulation is adequate. Because the mutual fund industry operates extensively in interprovincial and international markets, the legislation should if feasible be adopted at the federal level.

Of course, it would not be true to say that the Canadian mutual fund industry is currently unregulated. In the absence of a statute tailored to the industry, the provincial securities commissions have emerged as its principal regulators, exercising their authority under the prospectus filing and registration requirements. They have adopted a number of policy statements applicable specifically to mutual funds. Particularly since a number of these policy statements implement recommendations of the Mutual Fund Report, few or none are inconsistent with this report. The securities commissions have, however, recognized that a complete regulatory pattern such as that proposed by the Mutual Fund Report cannot be adopted through policy statements; it is noteworthy that Ontario's proposed Bill 154 reflects many recommendations of the Mutual Fund Report not previously adopted through policy statements. We believe that the industry can be effectively regulated only under a single regulatory pattern applicable to all Canadian funds.

While the detailed recommendations reflected in the proposed statute deviate in many particulars from the Mutual Fund Report, its general approach is the pragmatic one adopted by the Report. The mutual fund is regarded as a vehicle for the pooling of investments made by a number of investors in a single portfolio under common management, from which each investor may withdraw his proportionate share on demand. So regarded, the mutual fund is merely a tool to provide combined investment management. Acceptance of this approach affects many aspects of the legislative pattern. For example, it indicates that except in special circumstances the mutual fund should not be treated as a separate entity from its investment manager, requiring a separate board of directors. We have endeavoured to accept the implications of this underlying philosophy in the formulation of the rules in the proposed statute.

The fact that the mutual fund industry is currently regulated almost exclusively at the provincial level also caused us initial concern from a constitutional law standpoint. We concluded, however, that the present regulatory pattern is attributable to actions taken by provincial securities commissions to fill a regulatory void rather than to any constitutional or other consideration indicating that the regulation of mutual funds is inherently a matter of provincial responsibility. Research elicited little basis for the contention that federal power is inadequate and the report is premised on a comparatively wide view of federal power, reflected in the analysis prepared by Peter Hogg which is set out as an appendix. Still, the existing structure of provincial regulation is a fact which must be taken into account.

The conclusion that the proposed statute is constitutionally within the power of the federal Parliament did not end the consideration of provincial requirements. While the application of a comprehensive regulatory pattern at the federal level would have many beneficial results, its benefits would be largely negated if regulations were imposed federally which conflicted with those of the provinces. Hopefully, the adoption of federal legislation would be preceded or expeditiously followed by arrangements for federal-provincial cooperation which would prevent the application of duplicating or overlapping requirements at the two levels. In case this does not occur, care has been taken in the proposed statute to avoid regulations that are inconsistent with those of the provinces. In one important case, the regulation of distributors and salesmen dealing with the public, the proposed statute would rely directly on provincial regulation except with respect to the registration of the distribution company itself; this is discussed further in the commentary to section 9.03.

Mutual funds are currently subject not only to securities regulation but also, depending on their form of organization, to the corporation, trust, or possibly the partnership laws of the jurisdiction where they are organized. Particularly with corporate laws, these frequently contain provisions that deal with matters, such as shareholders' rights, which are also dealt with in the proposed statute. This overlap is necessary not only because the requirements of corporations statutes lack sufficient consistency to ensure uniform standards in the mutual fund industry but also because many of their provisions, being of general application, do not make adequate allowance for the special characteristics of the industry. In the provisions of the proposed statute that relate to matters customarily dealt with by corporation laws, as in those relating to matters affected by provincial securities legislation, care has been taken to prevent the adoption of inconsistent requirements. In several instances the requirements arising under the proposed statute might differ from, or be more onerous than, those of corporation laws but in each case it should be feasible for the affected organization to comply with both sets of requirements. In a few cases, for example with rules in corporation statutes which limit the sources available for dividend payments (commentary to section 3.04), we are sufficiently presumptuous to suggest possible changes in the corporation statutes.

Since the commentary to the proposed statute indicates the reasons for each of its provisions it is not necessary to deal here with the specific rules proposed in the statute. However, there are a number of concepts each of which influences many of the provisions and is therefore appropriately discussed here to avoid repetition in the commentary. Many of these concepts flow from the general philosophy alluded to above, that the mutual fund is a vehicle for the pooling of investments made by a number of investors in a single portfolio under common management from which each investor may withdraw his proportionate share on demand. While it is recognized that regulation should allow for maximum flexibility, certain constraints flow from this characterization of mutual funds. Some are inherent in the mutual fund form of organization while others arise from the nature of the market to which mutual funds have historically made their principal appeal.

Constraints inherent in the mutual fund form of organization result largely from the availability of the right to redeem which is the key attribute of a mutual fund. This right dictates constraints to avoid investments that would result in portfolios which could not be precisely valued or would be so illiquid as to make the redemption right unrealistic. This necessity of liquidity accentuates the need which exists with any financial intermediary to prevent misuse of assets. The fact that shares of most mutual funds are in the course of continuous public distribution requires special regulation of the sales function. Constraints inherent in the nature of the market to which mutual funds have historically made their greatest appeal include the necessity of rules to prevent the investor who looks on the mutual fund as a long term savings vehicle from being subject to the risks of an unusual or highly leveraged investment portfolio. However, if possible, the rules should be so formulated as not to prevent the organization of mutual funds with distinctive investment objectives designed to appeal to classes of investors with distinctive wishes or requirements.

The concepts that pervade the statute are largely designed to implement these approaches as effectively as possible. They are:

a) The mutual fund complex;
b) The distinction between conventional and non-conventional funds;
c) Control over sales charges and management fees;
d) Voting rights for investors;

e) Limitations on portfolio investments;

f) The disclosure pattern for investor education; and

g) The role of the administrator.

The mutual fund complex

The Mutual Fund Report S.1.02-1.07 noted that when the mutual fund is used as a technique for the pooling of money under common investment management, all gains and losses are passed through to the investors. This is done either directly by distribution of dividends or indirectly by changes in net asset value per share. This participation of investors in gains and losses is not present in other financial institutions and has made it necessary for the mutual fund organizer to obtain his entrepreneurial reward through contracts with the mutual fund rather than through equity participation. Thus the mutual fund is not organized as an independent business but is meant to be carried on in conjunction with the components through which the promoter obtains his profit. These components are the management and distribution companies which may be the same entity.

The management company through the management contract is compensated for administration of the fund and investment management. Through the distribution contract the distribution company is given exclusive rights to sell fund shares and, thereby, to collect the sales charges levied. In the usual case therefore the fund delegates all or virtually all administrative, managerial and distributive functions. Few, if any, funds have their own employees. To impose legislative commands on the fund itself would therefore be largely unrealistic. In addition, mutual funds are often organized as trusts which are not considered to be legal entities capable of assuming responsibility for legislative commands. At a legal level and at a practical level the fund must be considered in conjunction with its management and distribution companies to form one financial institution which we have called a mutual fund complex.

The proposals attempt to recognize the existing situation and allow the financial institution complete flexibility in organization. In section 3.01 it is provided that every mutual fund must have a management company and one or more distribution companies. Section 2.10 allows for an internalized mutual fund, that is one with management and distribution functions carried out by the fund itself, although this is not common in Canada or the United States so it is not stressed elsewhere in the proposals. Through the definitions of management company, management contract, distribution company and distribution contract it can be seen that the management and distribution arrangements can be set out in declarations of trust, contracts or any other manner thus allowing a complete flexibility of form for the organizer. The only limitation is that there must be one and only one management company for a given fund. We believe this is the fact in Canada today and it follows from the concept that the investor is buying a particular manager for his money.

While under the proposed statute responsibility would be visited in most cases on the complex rather than any particular component, flexibility is retained for the various components of a complex to divide up the statutory responsibility as they see fit. There is no concept of double responsibility. This is clarified in section 2.02. Normally the division of responsibility in a general way would be spelled out in the management and distribution contracts, which are required to be in writing under section 8.01. Subsections 2.02(3) and 2.02(4) make it clear that the contract can be specific, in which case it governs, but in cases where the contract is not specific then the factual situation, particularly the conduct of the manage-

ment and distribution companies shall be regarded as of central importance. We hope this gives the promoter flexibility to specify the important points in the contract without requiring those contracts to become cumbersone documents. To the extent not specified then the responsibility will follow the realities.

If the promoters desire to use an unincorporated fund the proposals would require the management company to carry out the statutory responsibilities otherwise visited upon the fund itself.

Distinction between conventional and non-conventional funds

So far as we are aware, there is no mutual fund in Canada today that would be classed as non-conventional under our proposals. It would have been a simple matter to prohibit non-conventional funds. But again we tried to permit flexibility and thus carry out the philosophy of the Mutual Fund Report.

The distinction between conventional and non-conventional funds results from the belief referred to above, that while legislation should take cognizance of the markets to which funds make their principal appeal and that this market is largely composed of long-term investors for whom an unusual or leveraged fund might well be inappropriate, resultant rules should not preclude the organization of funds designed to appeal to more specialized markets. The Mutual Fund Report segregated investors broadly into two categories, those who actively seek out mutual fund shares as investments and those who only buy mutual fund shares as a result of a sales effort. The former are referred to as the shopping goods sector and the latter as the unsought goods sector of the market for mutual fund shares. The Mutual Fund Report suggested that there would be nothing wrong in a promoter setting up a specialized mutual fund designed to cater to the particular needs of a class of investors in the shopping goods sector, so long as prospective investors were aware of the unusual attributes of the fund. So was born the concept of a non-conventional mutual fund with wider investment flexibility but more restrictive rules governing distribution techniques than are applied to other mutual funds. The name ''non-conventional fund'' was perhaps not the most felicitous as it raised the spectre in some minds of a very suspect animal — like a hippie, yippie or drug addict. In fact a non-conventional mutual fund should be nothing of the sort. One might be formed, for example, to invest largely in residential first mortgages which are hardly a highly speculative security by any normal definition. Yet we have been unable to devise a less unsatisfactory term and have therefore adhered to the nomenclature of the Mutual Fund Report.

The central distinguishing characteristics of a non-conventional fund are, then, wider investment flexibility coupled with narrower distribution techniques. If the investors in non-conventional funds could be confined to the shopping goods sector of the market there is no reason to impose rigid investment restrictions on them which are not imposed on other financial institutions. The restrictions on distribution techniques designed to limit the sale of shares of non-conventional mutual funds to the shopping goods sector of the market include the prohibition of the sale of shares by contractual plan and the restriction of advertising material used by the fund, with perhaps only advertisements of the tombstone variety being permitted at all. The relevant provisions appear in sections 2.07, 3.07 and 9.04. Once limited to investors in the shopping goods segment of the market then the fund would have wider flexibility in the selection of investments than would a conventional fund. The investment techniques proposed would be clearly delineated in the prospectus and summary

prospectus. If its organizers so desired and its stated investment practices so provided, a non-conventional fund could sell securities short and borrow money for leverage — both of which are well recognized investment practices. It must be stressed that not all non-conventional funds would do so and that many would not even have the power to do so in their investment practices. Short sales and borrowing would not be precluded, although a fairly severe limitation is imposed.

Under our proposals non-conventional funds would be prohibited from selling shares outside Canada in section 7.06. We regret that this provision is necessary but we believe it is for an interim period in view of OECD Proposals paragraphs 218-222. The international community, smarting from the wounds inflicted by Canadian-incorporated I.O.S., views non-conventional funds as a new weapon capable of causing harm. We hope this misconception will be put to rest as non-conventional funds show their true value as specialized funds rather than ''go-go'' funds. Flexibility within Canada should permit their establishment if, as we believe, there is a need for them.

One of the consequences of the Mutual Fund Report recommendations as modified in our proposals, which arose in the context of conventional and non-conventional funds, is that Canadian mutual funds would be permitted for the first time to borrow money for the purpose of investment. If a mutual fund incorporated federally were to borrow for investment it would probably become an investment company subject to the federal *Investment Companies Act.* That statute, designed primarily for closed-end investment companies, contains requirements which overlap substantially with the statute proposed by this report. No material regulation contained in the *Investment Companies Act* is omitted by our proposed statute and the latter deals with a number of matters that relate specifically to mutual funds and are therefore not dealt with by the former. For those reasons, and to avoid duplication of regulations, we suggest that if legislation such as we recommend is adopted, an appropriate exemption should be added to the *Investment Companies Act.*

Controls over sales charges and management fees

Consistent with the recommendations of the Mutual Fund Report these proposals do not contain requirements for boards of directors or trustees and therefore do not rely on the concept of directors or trustees independent of the management company. Instead other techniques have been utilized to control possible abuses while permitting flexibility. One such technique is the control over management fees and sales charges which fees and charges constitute the entrepreneurial reward for the promoter. To date in Canada the control of management fees and sales charges has been left to the provincial securities administrators who have published a National Policy Statement setting maximum management fees. These maximums have tended to become the standard for newly organized mutual funds. Our proposals favour, as the Public Policy Report and the Mutual Fund Report recommended, the concept of a reasonable fee in preference to a fixed fee schedule. What is reasonable for one fund may be totally unreasonable for another. The Mutual Fund Report S.10.73 envisioned that free and open competition amongst mutual funds would eventually be a good determinant of the reasonable fee. Clearly arbitrary limits set by an administrator may be too high to be reasonable for some and too low to be reasonable for others. The Canadian Mutual Funds Association in its recent brief on Ontario Bill 154 welcomed the idea of free and open competition. However, until that competition develops some forum for determining reasonableness must be provided. This is the thrust of sections 7.03-7.05 of these proposals. Essentially the management company or distribution company could charge any fee that the administrator agreed to be reasonable or, if he did not agree, that a court

could be convinced to be reasonable. In this way a flexible system is introduced which hopefully will lead to fees and charges which are realistic for both the entrepreneurs and the investors.

The Mutual Fund Report would have prohibited incentive management fees, a proposal not adopted in this report for the reasons set out in the commentary to section 7.04. Performance fees have been permitted in the United States although amendments to the legislation in December 1971 limited the types of allowable performance fees. More recently the SEC adopted Rules 205-1 and 205-2 under the *Investment Company Act* of 1940, which rules will become fully effective on December 1, 1973. These rules will make performance fees extremely difficult to arrange. Nevertheless we believe that if a reasonable base can be found the proposals should permit flexibility. Some may doubt whether any reasonable base can be found but that should be a decision for the administrator and the courts to come to on a case by case analysis.

Voting rights for investors

One of the techniques used in the proposals to ensure adequate investor protection is to provide some opportunity for shareholder participation in the way the fund is to be operated. Generally we do not view the investor as an initiator. We have provided in section 12.03 that the administrator may call a meeting of mutual fund shareholders. This would not be to vote on a particular item but to inform shareholders of some feature of the complex then troubling the administrator and elicit a response. This in turn might lead to action by the administrator himself. As additional shareholder participation we would permit the administrator to require a shareholder vote on the replacement of the auditor (section 12.01) and of the asset custodian (section 12.02). This accords with the Mutual Fund Report S.6.88 and 8.24. Shareholder voting is made mandatory on any material change in the management or distribution contracts, an amendment to the investment objectives or stated investment practices and in any transfer of control of the management company itself unless the management company is a listed company.

With respect to transfers of control the provisions of section 5.03 differ from the corresponding provisions in the Mutual Fund Report S.11.16-11.27, particularly in forcing a shareholder vote on actual changes of voting control of private management companies where the shares in the company are sold and in permitting the administrator to require a vote on other changes of control.

We believe that the required vote is appropriate where a management company is very closely controlled and that control is sold. The proposals do not prevent the transfer, which the Mutual Fund Report S.11.24 and 11.25 saw as a real difficulty, as that might be beyond the legitimate scope of a statute which did not incorporate the entity. But no management fee is payable in such event until the transfer is approved. We recognize the problems mentioned in S.11.25 of the Mutual Fund Report but we believe that since the investors bought management their choice should not lightly be taken away from them. Administrative intervention on a change of control is far more restricted however. There the ultimate remedy is the appointment of a receiver if the vote is negative. Such a course is obviously only to be pursued in the most serious cases.

Consistent with the recommendations of S.11.38 of the Mutual Fund Report we have provided machinery in section 8.02 for the nomination of alternate management. While again we believe this will only be pursued in serious cases we do believe it could have a

practical application; for example, the recent transfer of management away from Lifetime Financial Services Limited might have been resolved under such a section as 8.02 had it existed. It should be noted that both the incumbent and the nominee management company are prohibited from voting at the meeting in order to make sure it is the real investors who are making the choice.

Section 5.01 provides for a mandatory mailing to shareholders of material any shareholder wishes to have mailed out if the shareholder pays all the expenses. On a proposed change of management there is also provision for the mailing of one 1,000 word statement in favour of a new nominee. The protective subsections surrounding these mailings accord with the provisions of the proposed *Canada Business Corporations Act.*

Limitation on portfolio investment

As a further check on the management we have followed the recommendations in the Mutual Fund Report on limitations on portfolio investment. These are contained in sections 4.01 and 4.02. The provisions of section 4.02 may leave something to be desired but are modelled on the provisions of other financial intermediary legislation, such as the *Canadian and British Insurance Companies Act,* reflecting only those changes necessary for application to mutual funds. We followed the suggestions of the Mutual Fund Report in thus conforming with the provisions that have become relatively standard, since in our view when one is changed they should all be changed. Complementing these restrictions are the provisions of section 7.07 imposing the general duty on directors now found in most incorporating statutes (but not now applicable to unincorporated funds where the standard at common law may indeed be higher) and the liability for use of confidential information in section 11.04. We hope that, coupled with the surveillance technique recommended in secton 7.08, an effective civil liability remedy may be developed.

Disclosure pattern for investor education

The statutory restraints on insider misuse of confidential information are necessary elements of investor protection. They are by no means however the most important aspect as they really relate only to the unscrupulous insider. The real problem is to educate the investor so that he can make an informed choice to begin with — so that for him mutual fund shares will be shopping goods rather than unsought goods. Essentially this education is done at two levels — general education sponsored by government, the media or the mutual fund industry and specific education through the literature delivered to the investor to the extent he can understand it if he reads it. At the present time effective education by television is blocked in part by CRTC regulations prohibiting advertising of securities. These regulations should in our opinion be changed. In addition, the networks should attempt some investor education, perhaps with government support. In these proposals all that can be done is to set forth the requirement that advertising by a mutual fund complex through television or radio should be subject to preclearance by the administrator which is covered in section 9.04. Once an advertisement has been so cleared the CRTC should automatically approve it.

The literature received by a shareholder is more directly a concern of this statute. Section 9.04 of the proposals reflects the recommendations of the Mutual Fund Report S.14.79 requiring guidelines for sales literature. Closely allied to this is the annual report required in section 5.02 which is really a financial statement. If framed as the Mutual Fund Report recommended, which we have left for the regulations, the document would be of great assistance to anyone who read it.

The literature required on initial distributions will include a summary prospectus and a confirmation notice. Again we have followed the recommendations of the Mutual Fund Report. The summary prospectus is the key to these documents. If it is well set out it will be read. As it carries no civil liability for mis-statements there will be less tendency to make it verbose. Again the example set out in the Mutual Fund Report is enlightening. Disclosure is accepted as a method of investor protection in Canada despite the difficulties inherent in effective disclosure. As Emerson points out in Volume 2 of *Canadian Company Law* (edited by Ziegel, Butterworths 1973) direct disclosure of material facts provides the investor with an opportunity to make his own investment decision. That the summary prospectus would make this opportunity more of a reality than the prospectus now used can hardly be gainsaid.

The role of the administrator

Finally a word about the administrator and his role. Under section 13.03 of our proposals he would have a wide exempting discretion during a transitional period. We have also provided for advance rulings and publication of an index of administrative decisions. We regard the administrator as having principal responsibility for reconciling uniformity, flexibility and workability in the practical application of the regulatory pattern. The corporate statutes are not uniform, many corporate statutes of general application do not easily lend themselves to adaptation to mutual funds and many mutual funds are formed as trusts. The requirements should be roughly uniform and it will take a skilful administrator to fashion these proposals equitably to each fund to which they apply. We have attempted to indicate frequently the grounds for the exercise of any discretionary action permitted. But a general exempting discretion must be included in addition to any specific ones if mutual funds are to live in an international financial environment where adaptability to rapid change is a prerequisite to success. These proposals attempt to permit that adaptability while ensuring a framework for adequate investor protection.

COMMENTARY
PART I — Interpretation

1.01 Interpretation

It is difficult to write an explanatory note on the definitions used in the proposed statute without also explaining the context in which they are used. Of those definitions invented for this Act, most are best introduced by cross referring the reader to places where they are discussed in conjunction with the statutory provisions in which they appear. In that way the context of the use puts flesh on the dry bones of the definitions. The exceptions to this rule are ''mutual fund'' and ''mutual fund share'' which are used so frequently that they must be explained directly rather than by cross reference.

A mutual fund share is obviously a share issued by a mutual fund, but we have used it to define the key element of the fund itself, namely, the right of the shareholder to redeem at his option at net asset value per share. Accordingly, the two definitions ''mutual fund share'' and ''mutual fund'' tie together. This method of definition, as Baum has pointed out in his book, *The Investment Function of Canadian Financial Institutions,* is really defining the fund in terms of the instrument being sold rather than on the basis of competition for consumers' monies or, as the provincial securities law presently do, on the basis of continuous distribution of shares to the public. This definition is a direct result of the recommendations in the Mutual Fund Report, S.5.13. It may be argued that this type of definition invites easy evasion as restrictions could easily be put on the redemption right. To counteract this argument it is provided in the definition that a suspension of the redemption right does not make the share cease to be a mutual fund share. With this addition we believe we have captured the essence of that which distinguishes a mutual fund from other forms of investment vehicles. If the right to redeem at the holder's option does not exist then if the vehicle is selling shares and investing the proceeds in portfolio assets it is really just a holding company which it would not be appropriate to regulate under these proposals. The same focus on the right to redeem at the holder's option is found in the *Ontario Business Corporations Act* S.37.

The proposals permit any form of organization of a mutual fund such as a trust or corporation, within our definition of ''organization'' which in turn is largely derived from the dictionary. In some other statutes, such as the *Canadian and British Insurance Companies Act* the word ''corporation'' is used in one section to refer not only to incorporated bodies and trusts but to all forms of organization. We have tried to use the wider term ''organization'' as the reader is then put on notice that we are not simply speaking of incorporated bodies.

Most of the more important cross references to other terms defined in S.1.01 are as follows:

Administrator — the regulatory authority established under S.13.01, he appears in many sections of the statute.
Advertising material — S.9.01, 9.03 and 9.04.
Contractual plan — S.3.07, 5.05, 6.03, 6.05, 7.03, 8.02, 9.02, 9.05, 9.06, 10.03, 11.01 and 11.03.
Conventional mutual fund — S.2.07, 3.03, 3.07, 4.01 and 9.04.
Court — S.3.08, 5.01, 6.05, 7.03, 7.04, 7.05, 11.01, 11.02, 11.05, 11.07, 11.08, 11.09, 12.03, 12.04 and 13.01.
Court of appeal — S.11.08.
Director — S.2.06, 2.08, 4.02, 5.01, 7.08, 9.03, 11.06, 11.07, 11.09, 12.01, 12.03 and 12.04.

Distribution company — S.2.02, 2.04, 2.05, 2.06, 2.08, 2.09, 2.10, 3.01, 4.02, 5.03, 5.05, 7.02, 7.03, 7.08, 8.01, 8.02, 9.01, 9.02, 9.06, 10.01, 10.02, 10.03, 10.04, 11.01, 11.06 and 12.01

Distribution contract — S.2.02, 2.04, 5.03, 8.01 and 8.02.

Fund on funds — S.4.01, 6.05, 7.03 and 7.04.

Inappropriate investments — S.4.01.

Internally managed mutual fund — S.2.02 and 2.10.

Investment objectives — S.2.07, 4.01 and 5.03.

Investment practices — is used in the definition of "stated investment practices".

Issue price — S.3.01, 6.01, 6.04, 7.02 and 9.05.

Management company — as expanded by 1.01(5) — S.2.02-2.06, 2.08-2.10, 3.01, 3.03, 4.02, 5.01-5.03, 7.04, 7.08, 8.01, 8.02, 10.01, 11.01, 11.05 and 12.01.

Management contract — S.2.02, 2.04, 3.01, 3.03, 5.03, 7.04, 8.01 and 8.02.

Management expenses — is used in the definition of management expense ratio.

Management expense ratio — S.9.04.

Minister — S.12.03, 13.01, 13.02 and 13.04.

Mutual fund complex — S.2.02, the term is used in most sections of the statute.

Net assets — S.3.03-3.05, 3.07, 4.01, 6.01 and 11.01.

Net asset value per share — S.6.01, 6.02, 6.04 and 11.01.

Net liquid assets — S.3.03.

Non-conventional mutual fund — S.2.07, 3.03, 3.07, 4.01, 7.06 and 9.04.

Organization — is used in the definitions of mutual fund, mutual fund share and share, and in S.4.01, 4.02, 5.05, 7.08, 11.06, 12.01 and 13.03.

Outstanding — is used in the definition of net asset value per share, S.3.03, 3.07, 4.01, 4.02, 5.01, 6.01, 6.02, 6.05, 8.02 and 12.04.

Permitted investment — S.4.01, 6.04.

Person — appears throughout the statute.

Planholder — S.3.07, 5.05, 7.03, 11.03.

Portfolio assets — S.3.03, 3.09, 4.01, 6.01, 6.04, 10.01, 11.01, 11.04 and 12.02.

Redemption price — S.6.01, 6.03, 7.03 and 9.05.

Restricted investments — S.3.03, 4.01, 6.04 and 11.02.

Sales charge — S.7.02, 7.03, 7.05, 9.03, 9.04, 9.05, 10.04, 11.03 and 11.06.

Sales literature — S.5.02, 9.01, 9.03 and 9.04.

Security — S.3.02, 3.03, 4.01, 5.03, 6.02, 6.04, 7.03, 7.04, 7.08, 8.02, 10.01, 11.05, 12.03 and 12.04.

Share — is used in the definition of mutual fund share and elsewhere throughout the statute.

Short sale — S.3.03, 4.01 and 6.01.

Stated investment practices — S.2.07, 4.01, 5.03, 6.04, and 11.02.

Unrealized capital gain — S.3.04.

Associate — as expanded in S.1.01(3) and 1.01(6) — S.4.02, 5.03, 6.03, 7.08, 8.02 and 11.01.

Related mutual fund — S.4.01.

PART II—APPLICATION AND REGISTRATION

2.01 Mutual Funds Subject to Act

We have assumed for the purposes of these proposals that the federal government has full power and authority to regulate any type of mutual fund organized in Canada whether incorporated or unincorporated, whether acting entirely within one province or in several provinces. We have assumed a similar jurisdictional base with respect to funds formed in Canada but selling only outside the country and with respect to funds organized outside Canada but distributing shares inside Canada. The constitutional law considerations that have led us to accept these assumptions are set forth in the appendix prepared by Peter Hogg.

It might be contended that even if constitutional law permits the Canadian federal government to regulate Canadian organized mutual funds where securities are distributed exclusively outside Canada, this regulation is unnecessary. We would disagree with this contention. We believe that Canada's reputation is affected by sales of Canadian organized mutual funds in other countries. The I.O.S. organization, the notoriety of which is now catholic, has blemished Canada's reputation abroad. It was not a situation with which the provincial authorities could be expected to cope although they did participate in international attempts to clear up the mess. Accordingly, we have brought under the umbrella of the statute all Canadian organized funds. This jurisdiction is required under paragraph 209 of the OECD Proposals.

We believe that investor protection in Canada demands the regulation of all mutual funds whether domestic or foreign based whose shares are sold in Canada. To provide otherwise would invite evasion by, for example, a series of trusts which operate entirely within each of the various provinces, with some form of interrelation between the trusts that might be difficult to trace. We believe that a single regulatory scheme across the country is needed and should be provided by the federal government through the exercise of the constitutional authority described in Peter Hogg's memorandum. Indeed the new *Income Tax Act* has favoured the mutual fund trust as opposed to the corporate entity, a fact which may make regulation at a provincial level even more difficult with respect to sales outside the province. However, in so far as foreign-organized funds are concerned if Canadian law were to provide for automatic statutory application to those funds, problems of international comity would arise. Accordingly, under the proposals the funds would be required to be licensed but sales in Canada of their shares would be prohibited until the license was issued.

We have also provided for voluntary registration of any mutual fund that would not otherwise be required to register under these proposals. It may well be that funds will seek to register even if not forced to. A similar concept is contained in Part IX of the *Canadian and British Insurance Companies Act*. We have provided that two classes of mutual fund are exempt from registration under the statute. One exemption is for a separate fund maintained within a life insurance company because we feel it is arguable that such funds should be regulated by the authorities regulating other forms of insurance, an argument advanced in the Mutual Fund Report S.5.45. While this approach places these funds in the ambit of the insurance regulatory authorities, it is appropriate for us to note our view that those authorities should regulate such funds in much the same way as mutual funds are regulated under this Act, for in the absence of equivalent regulation of the two vehicles, unfair advantages might be alleged to arise for one or the other. This consideration would appear to support the regulation of separate funds by the proposed mutual fund legislation, but we recognize that the insurance companies would have a valid complaint if they were regulated by separate

authorities whose requirements might conflict. It is for that reason alone that the exception has been permitted. If the insurance regulators do not adhere to a similar form of regulation then statutory changes would have to be made.

We have also provided an exception from all provisions of the statute for mutual funds which have less than fifty shareholders.

The various provisions of this section are derived from S. 5.19, 5.47, 7.20, 16.40 and 16.51 of the Mutual Fund Report. Reference may also be made to paragraph 216 of the OECD Proposals.

2.02 Application to Mutual Fund Complex

The method of organization of mutual funds has led us to adopt as a principal element in these proposals a new concept—the mutual fund complex. This is a natural result of our belief that the mutual fund and its management and distribution arrangements should be regulated as a whole in spite of the fact that the management and distribution functions are ordinarily carried out by one or more organizations separate from the mutual fund and that the allocation of responsibilities among those organizations is not uniform. Nor have we wished to dictate uniformity. These considerations lead, in our view, to the conclusion that most legislative requirements should apply to the mutual fund complex composed of the fund and its management and distribution companies but that guidelines should be provided as to the allocation among them of responsibility for compliance with the rules. This is done by section 2.02.

Section 2.02 preserves maximum flexibility by permitting more than one distribution company. The likelihood that an organization would wish to have more than one management company is remote. Accordingly, the complex is viewed as a single mutual fund together with its single management and several distribution companies. How responsibility is divided among these components will depend on the arrangements established for any particular fund complex. Under section 2.02, resort would be had initially to management and distribution contracts to delineate the responsibility. In practice one component may perform a given function despite an apparently contrary intention expressed in the written documents. In such a case subsection 2.02(3) provides that the fact will govern rather than the relationship dictated by documents.

The intent of this section is to allow flexibility in allocation of responsibility. Yet a legislative subject must be preserved, since mutual funds organized as trusts may not be considered to be legal entities. For unincorporated funds this legislative subject is deemed to be the management company. In other cases it is left to the arrangements specified by the parties.

While this concept is consistent with several sections of the Mutual Fund Report, such as S.9.32(8), 6.01 and 6.05, it is new in these proposals. The closeness of the relationship between the various components of a mutual fund complex has been recognized in the United States by revised S.36 of the *Investment Company Act.*

2.03 Required Registration Date

The proposals allow a one year grace period to enable existing funds to comply with the statute. There are numerous transitional provisions throughout the statute and we believe

that they in combination with the one-year period will prove realistic and appropriate to enable the industry to adapt to the new requirement. There is no intention to disrupt the industry by forcing compliance with impracticable timetables.

2.04 Registration of Management and Distribution Companies

If the Act is to regulate mutual funds it must also regulate their management and distribution functions. As these are carried on in separate entities in the usual case it is necessary for the management companies and the distribution companies to register. Accordingly, these proposals envisage the registration or licensing of each part of the mutual fund complex in order to effectively carry out the approach described in the commentary to section 2.02. This was suggested by S.7.20 of the Mutual Fund Report and is consistent with paragraph 135 of the OECD Proposals.

2.05 Duration of Registration

There must be some provision to allow mutual funds to de-register when the statute should no longer apply to them. That is the sole purpose of this section. It is, therefore, an adjunct of the earlier sections which implement the recommendations of the Mutual Fund Report and the OECD Proposals. In view of section 2.04(2) there is no need for a similar provision to deregister management and distribution companies.

2.06 Registration Procedure

The registration procedure we believe is self-explanatory. The proposals envisage registration to be as of right rather than discretionary, a concept now becoming accepted in Canadian business corporation statutes. This idea is very important as we do not feel that the administrator should have a discretion to keep out a mutual fund or its management company or its distribution company if organized within Canada. There would be a certain discretion with respect to the registration of salesmen, a subject which is explained in more detail in section 9.03. But with respect to the mutual fund complex we believe registration as of right is appropriate. We also believe that the operation of the regulatory pattern is appropriate whether or not the complex in fact registers. The only exception is for funds organized outside Canada. Here, as explained in section 2.02, the only practical solution is to prohibit share sales in Canada until a license is obtained. In effect this procedure implements S.7.20(2) of the Mutual Fund Report. It is in accordance with paragraph 209 of the OECD Proposals.

2.07 Election to be Non-conventional Fund

The whole concept of a non-conventional mutual fund is thoroughly dealt with in the Mutual Fund Report S.12.30ff. We do not feel it is essential to repeat all the arguments in favour of non-conventional mutual funds stated within that Report. So far as we are aware, there are no mutual funds operating in Canada today which would be non-conventional funds under our proposals. This may be because the provincial securities administrators, lacking such a special category, have found it necessary in the public interest to discourage the creation of mutual funds with the type of special interest objectives that non-conventional funds would have.

In accordance with the Mutual Fund Report, the proposals are designed to impose sales restrictions on non-conventional funds so that their shares will be successfully distributed only if prospective investors seek them out for investment rather than being sought out by

them. Under section 3.07 of the proposals the distribution companies of non-conventional funds would be prohibited from selling shares pursuant to contractual plans as that might invite too vigorous a level of sales efforts. Advertising should also be severely curtailed by regulations adopted under section 9.04.

The investment restrictions applicable to non-conventional funds while much less restrictive than for conventional mutual funds, are not meant to be an invitation to greater risk taking but rather to more selective investment directed at different objectives than is the usual case for conventional mutual funds. In addition, under the proposals the administrator would have considerable discretion with respect to the rules applicable to non-conventional mutual funds, which we believe to be appropriate to ensure that they do not develop in an unstable manner. In a country such as Canada flexibility within the regulatory framework is essential if new initiatives by financial intermediaries are not to be thwarted.

It is noteworthy that part of the international community, as evidenced by paragraphs 218 to 222 of the OECD Proposals, is reluctant to see non-conventional funds develop at all. We believe that our proposals strike a reasonable balance and include precautions sufficient for investor protection while allowing flexibility for financial innovation. In deference to the feelings of the international community we have, however, included a provision (section 7.06) which would prohibit the international sale of shares of Canadian organized non-conventional funds.

Under the proposals, there need be no explicit shareholder approval of the election to change from a conventional to a non-conventional status. However, such a change would require amendments to the investment objectives which would necessitate shareholder approval under section 5.03.

The specific recommendations of the Mutual Fund Report can be found in S.12.39.

2.08 Changes in Information Filed

This section is really self-explanatory but is obviously necessary for the purposes of completeness. We have adopted the approach used in S.35 of Bill 154 although our requirements are perhaps less detailed.

The approach is consistent with the approach recommended in the Mutual Fund Report, see for example S.7.20.

2.09 Duplication

A general provision has been included pursuant to which the administrator can waive compliance with any provision of the statute upon such terms as he sees fit if the laws of another jurisdiction have or another statute has provisions which yield approximately the same protection for the investor. We anticipate that this authority would be cautiously exercised. For example, we doubt whether the administrator would or should waive compliance with restrictions on sales activities for a foreign mutual fund complex if it intended to undertake strenuous sales efforts in Canada. However, the proposals allow for flexibility without giving the administrator an absolute exempting power. In the usual case the condition would be imposed that copies of all reports filed in the other jurisdiction be filed with the administrator.

This proposal is considerably narrower than the complete discretion suggested in the Mutual Fund Report, S.7.20. It is closer to the provision of S.6(c) of the *Investment Company Act* which includes a requirement to consider the protection of investors. It is consistent with the approach contained in paragraph 209 of the OECD Proposals.

2.10 Internally Managed Mutual Fund

We do not know of any mutual fund which is internally managed and operates in Canada. However, one large mutual fund organization in the United States, The *Broad Street Complex,* does operate without either a management or a distribution company. We can see positive advantages to having an internally managed mutual fund. However, it would be difficult to frame each provision in the statute in such a way that it would apply with equal facility to a fund which did not have either a management company or a distribution company. Accordingly, under our proposals the administrator would have discretion to fashion the statute to suit the internally managed mutual fund if such a fund registers with the administrator. As it is not a present problem in Canada we do not feel that further recognition for an internally managed mutal fund is necessary in these proposals. Its inclusion is consistent with the policy of allowing maximum flexibility for differing organizational structures, which is a major theme of these proposals.

This section is based on the recommendations of the Mutual Fund Report, S.6.89-6.95. Further discussion of the U.S. experience can be found in The *Public Policy Report* relating to The *Massachussets Investors Trust,* a huge fund that was internally managed in 1966 but changed to an external management arrangement in 1969.

PART III—GENERAL REQUIREMENTS GOVERNING THE OPERATION OF MUTUAL FUNDS

3.01 Relationship with Management and Distribution Companies

Except for internalized funds discussed in the commentary to section 2.10 all mutual funds registered or licensed under our proposals would have a management company and one or more distribution companies. In many cases a single company would be both the management and the distribution company. This section is designed to implement this intent. It should be considered together with the definitions of management company, management contract and distribution company in section 1.01. The provisions should provide as much flexibility as the industry requires.

The restriction to a single management company is consistent with the view set forth in the Mutual Fund Report S.6.04 and 11.04, that the mutual fund is used by the management company to sell its investment advice to the public. The definition of management company is so designed that this restriction would not prevent a management company from receiving advice from a number of investment advisors. The concept of multiple distribution companies is consistent with the approach set forth in S.1.04 to 1.08, 6.01 to 6.12 and 11.01 to 11.04 of the Mutual Fund Report.

3.02 Equity Capital

The proposals provide that all the shares or units in a mutual fund should be equal in their claims against the assets of the fund. This provision comes directly from S.5.66 of the Mutual Fund Report and is consistent with the approach taken in the *Public Policy Report.* The existence of various types of equity securities with unequal claims against the assets would make the determination of net asset value per share, which is crucial to the operation of the fund difficult, if not impossible. There appears to be no valid reason for having participating securities with unequal claims in situations where such securities are redeemable at the holder's option. The disclosure problems associated with explaining to the unsophisticated investor how differing claims could affect his redemption value is an equally important consideration in our view. Thus simplification and workability both favour prohibiting shares with differing participating claims.

This does not mean that an incorporated mutual fund will be forced to have only one class of shares. To do so could be contrary to existing provisions in some of the statutes under which mutual funds are incorporated, which demand that at least one class of shares not be subject to any right of redemption. Throughout these proposals we have tried to avoid any such conflict with existing incorporation statutes. It is not essential under these proposals that the voting rights of all shares be identical nor that shares which are not distributed to the public be redeemable at the option of the holder. Thus shares of the original promoters could be denied redemption rights. Except where certain fundamental decisions are taken, as set out in section 5.01, shares owned by the promoters could be the only voting shares.

It is now generally accepted that the existence of options or warrants to purchase shares in a mutual fund at prices which do not reflect the net asset value per share at the date of exercise is not appropriate. A rule prohibiting such arrangement has been suggested in the OECD Proposals paragraph 190 as well as in the Mutual Fund Report S.5.66. The possibility of dilution of the net asset value per share by the exercise of outstanding warrants makes

an accurate calculation impossible. The rewarding of management for good performance, which is a common reason for the issuance of options can easily be done in other ways and should not be done through the mutual fund in any event. Because some existing funds may have warrants or options outstanding the provision is only drafted to stop issues after the proposed statute becomes law. While the prohibition against issuing shares at other than the net asset value per share at the date of issue makes this provision technically unnecessary, it may help to avoid any possible misunderstanding. The wording of the prohibition is designed to have no effect on letters of intent or contractual plans where the holder is obliged to pay for his shares at the net asset value on the date of issue.

The distinction made in corporate law between par value and no par value shares is not relevant for mutual funds. In corporate law, par value is sometimes used as the basis for restrictions on the sources of money available for the payment of dividends and for the redemption of shares. Such restrictions are not necessary for mutual funds under our proposals because of the limitations on borrowing by the fund, contained in section 3.03. Accordingly, there is no need to deal in these proposals with the question of par value and no par value shares. Some incorporating statutes require par value shares while some do not. Either system is consistent with these proposals as the provisions concerning sale price and redemption price are in no way related to a stated capital concept.

There is nothing inherently objectionable in the reissue of securities by any entity unless it affects the rights of existing shareholders. As all the shares of a mutual fund would have equal claims against its assets under subsection 3.02(1), which reflects current industry practice, there seems to be no reason to prohibit the reissue of shares previously redeemed. The proposals therefore contain no such restriction although they would not affect requirements applicable to some incorporated funds obliging them to apply to the incorporating authority for additional authorized capital under the incorporating statute. We would hope that incorporation statutes containing such obligations would be revised to permit mutual funds to reissue their shares as of right.

3.03 Borrowing

A mutual fund might borrow money for any of a variety of reasons and in any of a variety of forms. The forms include margin accounts, demand loans from banks or other institutions, loans from individuals or corporations closely associated with the fund, short term loans from institutions and medium or long term loans either from institutions or as the result of a publicly placed debt security issue. Any borrowing could be secured or unsecured. The reasons include:

a) A belief that the money borrowed can be invested to yield a better return than the interest payable on the loan (often called ''borrowing for leverage'').

b) To finance an expenditure to be made by the mutual fund which exceeds the value of available cash and liquid assets that the fund is prepared to liquidate.

c) To finance cash requirements during periods when temporary exigencies make it impracticable to liquidate assets which the fund would otherwise liquidate to cover the necessary expenditures.

The typical Canadian mutual fund does not borrow money at all or borrows only on a demand loan basis to meet emergencies. The most obvious emergency occurs when there is a heavy demand for redemptions which could only be met by selling portfolio investments at distress prices. To guard against such an emergency mutual funds usually maintain a

healthy cash position. Nevertheless emergencies can arise and in our view borrowing to meet such emergencies should not be prohibited. On the other hand, borrowing for leverage is generally regarded as inappropriate for the conventional type of mutual funds. If large scale borrowing, or borrowing on the public market were to be permitted, consideration should be given to protection for the lenders which might involve some curtailment of the rights of shareholders.

The risk of loss to the mutual fund shareholder also increases as borrowing increases, not only because borrowing for leverage can have the reverse of the hoped-for effect if the yield on the borrowed money is less than the interest paid thereon but also because the loan may have to be repaid at an inconvenient time from the point of view of the mutual fund. Accordingly, severe limitations on borrowing by mutual funds have been recommended in the Mutual Fund Report S.5.78 and the OECD Proposals paragraph 100. There are limitations on borrowing now imposed in the United States under the *Investment Company Act* section 18(f) and in Canada by the regulations of the Canadian Mutual Funds Association. The question really is the scope of the necessary limitations, which may vary depending on the type of mutual fund. If the asset portfolio is highly liquid then borrowing may be less of a problem than it would be for a fund with less liquid investments.

If the loan is for a specified time period and not subject to be discharged at the option of the mutual fund, the liquidity of the fund is reduced. We believe that borrowing should only be used sparingly by any mutual fund and it is proposed that no mutual fund shall enter into any borrowing arrangement unless any loan made pursuant to such arrangement can be discharged by the fund at any time without notice or bonus.

For a mutual fund to give security for a loan seems at first blush to be inappropriate because it limits the fund's ability to sell the assets subject to the charge during the term of the loan. However, if the loan is repayable without notice or bonus then the problem disappears so long as the mutual fund can sell the underlying security to repay the loan if it so chooses. Because of the quantitative limitation suggested for borrowings a fund should always be able to arrange either for the release of the securities or for alternate unsecured borrowing in order to repay a secured loan. Accordingly, no prohibition against giving security on loans has been proposed.

The Mutual Fund Report and existing practice both in Canada and in the United States support the concept that public debt issues by mutual funds are inappropriate. Protection of the lenders would be required if such debt placements were allowed. In any event they are unrealistic if repayable at any time by the fund. They have therefore been prohibited under our proposals.

It is desirable to set a quantitative limit on borrowing which, while generous, would prevent abuse of the borrowing privilege. For conventional mutual funds a limit of 15% of net assets was proposed by the Mutual Fund Report and has been accepted by the CMFA. The OECD Report suggested a 20% limit while the limit in the United States appears to be 33%. We have adopted the more conservative 15%.

Non-conventional funds are treated quite differently in the Mutual Fund Report, which recommends that they be permitted to borrow as much as 75% of a borrowing base calculated on the basis of liquid assets less total liabilities. Included in liabilities is the potential liability on any short sale, short sales only being permitted for non-conventional funds. The

formula we have adopted would limit the maximum liability for borrowing or short sales by the defined term, net liquid assets, which is the equivalent of the borrowing base proposed in the Mutual Fund Report although it differs in some details from the proposal in the Report. The definition incorporates the concept of restricted investments in that the maximum amount of borrowing permitted would be reduced as restricted investments are made (the extent of such investments being itself limited under section 4.01). For example, a non-conventional fund permitted to borrow up to 40% of its borrowing base and which had $1,000 in liquid assets and no liabilities could borrow $400 for uses other than the acquisition of restricted investments. By so doing it would increase its assets to $1,400 but the net liquid assets would stay at $1,000 as the liabilities would have risen to $400. If, however, it wished to apply the borrowed money to the acquisition of restricted investments, the maximum borrowing would be approximately $285. After the borrowing and the acquisition, the borrowing base would be $715 (i.e. net assets less restricted investments), 40% of which is approximately $285.

Until non-conventional mutual funds start to operate it is difficult to assess whether the limitation is realistic. It is one of a number of items which may need to change as experience with this type of fund increases.

We have already explained why we believe that public borrowings by mutual funds should not be permitted. In addition the Mutual Fund Report recommended that only institutional lenders duly licensed to loan money should be permitted sources of mutual fund loans. This would eliminate the conflict which could arise if borrowing from associated persons not usually in the lending business were permitted. In addition the Mutual Fund Report deemed it advisable to exclude loans from brokers, even if they are otherwise within the definition of institutional lenders, in order to avoid potential abuse. An exception to the institutional lender requirement would have been permitted under the Mutual Fund Report for emergency borrowings of up to 5% of net assets, so that such borrowings could be effected from associated companies including the management company. This suggestion has been adopted although we believe borrowing to the limited extent permitted under our proposals could usually be arranged quickly through the regular lending channels and would be preferable. In addition, under the proposals a management company would be permitted to lend money to its mutual fund without interest but only if the loans are within the applicable percentage limitations.

The proposals prohibit borrowing assets other than money as such borrowing is not appropriate for a mutual fund. An exception which is consistent with the *Investment Company Act* and the recommendations in the Mutual Fund Report, is included in the case of non-conventional funds for loans of securities from brokers to cover permitted short sales. Again experience will be needed to evaluate the correctness of this provision with respect to non-conventional funds.

The Mutual Fund Report suggested that borrowing by conventional mutual funds should be allowed only to meet redemption calls, a recommendation now adopted by the Canadian Mutual Funds Association. While we believe that many funds will only borrow as a last resort to meet calls for redemption, we think it is very difficult in practice to determine the purpose for a borrowing. Because the borrowing limitation is set at only 15% of net assets for conventional funds we have concluded that there is little utility in asking the fund to ascribe a purpose to its borrowing. Thus we have not adopted the proposal in the Mutual Fund Report that borrowing by conventional funds be conditioned on the purpose of the loan being to meet redemptions.

3.04 Source of Funds for Dividends

The sources of funds available for redemptions and dividends is obviously important to a mutual fund. As many funds are incorporated, one would expect that corporate law could be looked to as a helpful guide. Under the early corporate common law and under most early incorporation Acts it was illegal for a corporation to pay dividends or to redeem shares out of stated capital. While that provision is no longer relied on to the same extent in most modern business corporations Acts, its memory lingers on.

It would seem logical to permit the same sources to be used for redemption as for the payment of dividends. Yet, for example, the proposed Canada Business Corporations Act prohibits dividend payments out of stated capital but permits redemption payments to be made out of stated capital.

It must be realized that in calculating the net asset value per share for a mutual fund, unrealized capital gains, stated capital, retained earnings and realized gains are all included. The result is that shareholders who exercise their redemption rights receive an amount that reflects, among other things, unrealized gains. This has not caused any problem of which we are aware. The OECD Proposals, the Mutual Fund Report and the legislation in the United States all force such a result because of the method of asset valuation.

In theory, if there is no restriction on the source of funds, including unrealized capital gains, which a shareholder should receive on redemption it can be argued that there should be no restriction on dividend payments either. Such is the recommendation of the Mutual Fund Report S.5.72. However, both the OECD Proposals paragraph 185 and the *Investment Company Act* section 19 require that unrealized capital gains not be distributed by way of dividend.

It is possible to have a situation where the directors wish to pay dividends based on unrealized capital gains. While the logic of permitting such a payment may be compelling in theory, in practice the unrealized capital gain may quickly evaporate. In order to stay on side with the international community we have adopted the OECD Proposal so far as it relates to payments of dividends from unrealized capital gains. We have left it to the incorporating jurisdiction or the jurisdiction in which a mutual fund trust is domiciled to prescribe any other amounts that may not be paid out by way of dividend.

The prohibition against paying dividends out of unrealized capital gains may induce a fund to realize a capital gain in order to pay a dividend. This could result in sales at a time when such selling was inappropriate. In the United States a prohibition against payment of dividends out of capital gains more than once in any given year is now set forth in S.19(b) of the *Investment Company Act.* No similar prohibition is contained in these proposals. It is an area on which the administrator should keep an eye with a view to suggesting amending legislation if required. We do believe that there should be a possibility of passing regulations restricting the number of dividend payments in any one year if such a restriction appears to be necessary. This would allow for some flexibility without awaiting a full amendment to the statute. That provision is contained in the general provisions relating to regulations in section 13.04(1)a).

3.05 Capital Requirements

When one speaks of the capital requirements of a mutual fund the word capital is used in the sense of net assets rather than equity contributed. Protection of lenders, which is one

reason for the requirement of minimum capital in some circumstances, is not really relevant to a mutual fund as has been explained previously. The requirement of a minimum amount of net assets is introduced for at least five reasons:

a) To provide a cushion in case of financial difficulties;
b) To ensure the availability of sufficient assets to allow for at least some diversification;
c) To ensure that the entrants to the industry maintain a long term interest in the funds they start;
d) To give the administrator a control mechanism; and
e) To provide for liquidation costs if necessary.

At least two of these five reasons [i.e. c) and d)] dictate that the capital requirements be identified with the management of the fund. Indeed, so long as the minimum amount were available to defray liquidation costs the capital requirements could be required in either the management group or the fund itself as the promoters preferred, a flexibility which should not lightly be denied. However, that is not so of reasons a) and b). Accordingly, it is necessary to require the minimum capital be invested in the fund.

Funds that are issuing contractual plans should have a significantly greater stability than those selling only on a day by day basis since a contractual plan often spans ten years or more and the investor is entitled to some assurance that the organization to which he is committed for so many years is a stable one. His concern is accentuated by the fact that a contractual plan requires a ''front end load'', which means that a higher proportionate acquisition fee is paid in the initial as opposed to later years. This part of the statute deals only with the characteristics of the mutual funds themselves as opposed to the management and distribution companies and the reasons for imposing capital requirements necessitate a broader discussion. The minimum capital requirements of the management company and of the distribution company are considered in Part 8. The interrelation should be kept in mind however.

The Mutual Fund Report S.7.44 suggested a minimum net asset requirement of $100,000 before a fund could offer its shares to the public. An additional $900,000 in net assets would be required before such shares could be sold under a contractual plan, which is covered in section 3.07. It also recommended that the amount of these minimum requirements should be left for the regulations with a discretion in the administrator to reduce the minimum amount if appropriate. The *Investment Company Act* S.14 and the OECD Proposals paragraph 124 favour a minimum capital of at least $100,000. We have found it difficult to imagine when a capitalization of less than $100,000 would be sufficient. Accordingly, we have not left a residual discretion in the administrator but have provided that the minimum can be increased in the regulations.

In order to ensure a continuing commitment by the management of the fund the Mutual Fund Report S.7.44 suggested that securities to the value of $50,000 should be made subject to an escrow agreement with a trustee acceptable to the administrator. The beneficial owners would be entitled to exercise any voting rights attached to such securities and to receive dividends declared on them. The proposals adopt this requirement which is in addition to similar requirements which may be imposed by other countries where the fund was formed or operates. This is consistent with the view that the escrowed securities form a protective base for the Canadian investor.

An additional $50,000 to form the minimum of $100,000 is not required to be escrowed under the recommendations in the Mutual Fund Report, but it was suggested that the holders of additional mutual fund shares having a value of $50,000 agree in writing not to redeem such securities unless, after such redemption, the net assets of the mutual fund would be in excess of $300,000. The proposals carry out this recommendation.

3.06 Prospectus

Traditionally a prospectus has been expected to contain full, true and plain disclosure of all material facts relating to the mutual fund. In an effort to fulfill this expectation the issuer and its lawyers have felt obliged to construct a document which is often far from a model of luminosity. Accordingly, the full prospectus presently fulfills more of a role as an information base for the regulatory authorities and the financial analysts than as a useful information source for the prospective investor. Because it is viewed as too complicated to be an effective selling document, salesmen have come to rely on other sales literature and a verbal presentation. The prospectus is delivered mainly to protect the fund and the distribution company from possible attack at a later date.

The Mutual Fund Report S.14.50ff. recognized the inadequacy of the prospectus. It recommended the introduction of a simplified summary document which would be reviewed by the regulatory authorities and which would become the basic selling document. It would be short and readable. The Mutual Fund Report recommended a summary prospectus containing a precis of the narrative portion of the full prospectus with cross references to the full prospectus. The example set forth in the Mutual Fund Report at page 536 is in such form as clearly to invite the prospective investor to ask for a full prospectus, a right he was intended to have. Under the Mutual Fund Report, the summary prospectus could not be used as the basis of a civil suit based on a misrepresentation or omission which was fully covered in the full prospectus as it was felt this would lead to a less intelligible document.

An alternative solution, suggested in recently proposed provincial legislation, is to have a new document called an "offering circular" the contents of which would be specified in the regulations. Civil liability could be based on misrepresentations or omissions in the offering circular. This liability provision, if enacted, could force the offering circular to become a second lengthy unintelligible document. If the full prospectus is complete and not misleading it would appear that the regulatory authorities should be able to say that the offering circular or summary prospectus is an adequate presentation for the purpose of prospective investors. The other solution puts less responsibility on the regulatory authority but it may be at the expense of clarity for the investor. This section adopts the proposal in the Mutual Fund Report.

The prospectus and the summary must be filed with and accepted by the administrator under the recommendations in the Mutual Fund Report S.14.61. Acceptance, accomplished by issuing a receipt, is necessary as both documents are to be vetted by the administrator. The full prospectus would be filed annually, be available to all mutual fund shareholders and be delivered to all prospective purchasers who desired it. Delivery rights are covered in section 5.04.

It should be noted that the preparation and filing of the full prospectus every year is mandatory only if the fund continues to sell securities. While we agree with those who hold that existing and potential shareholders have similar informational needs, at least if they are shareholders in open-end mutual funds, it may be a considerable expense to file a new

prospectus each year if the fund is no longer offering securities to the public. This section permits the mutual fund which is no longer offering securities to the public to file either a prospectus or an expanded annual report together with any supplementary material the administrator may require to keep a current file on the fund for the use of analysts.

We believe that existing shareholders of a fund which is offering its shares to the public should, on request, be entitled to complete, up-to-date information on the fund. The easiest way to provide for this is to require an annual prospectus which need not be sent to each shareholder but which is available on request. Such availability should be noted in the annual report. The fund could, it it so chooses, combine the annual report and the prospectus into one document. This has not been made a requirement however for two reasons. First, the cost might be exorbitant. Second, it is doubtful if the recipient would or could read it intelligently. It is better to provide shareholders with a concise, readable annual report than a bulky document which, at best, is difficult to comprehend. This approach is recommended in the Mutual Fund Report S.14.122.

3.07 Limitations of Funds Selling Contractual Plans

Frequent references are made in these proposals and the Mutual Fund Report to contractual plans and limits that should be imposed on them. While it might be preferable to group such provisions we have felt this would obscure rather than clarify the general thrust of the proposals. This section deals with the direct limitations on the ability of a mutual fund complex to sell shares pursuant to a contractual plan. In essence we have proposed the three restrictions suggested in the Mutual Fund Report for a complex issuing contractual plans:

a) That the fund have net assets in excess of $1 million (Mutual Fund Report S.7.54).
b) That the fund be a conventional as opposed to non-conventional mutual fund (Mutual Fund Report S.10.125).
c) That an acceptable custodian service the contract (Mutual Fund Report S.8.64).

The Mutual Fund Report contains a detailed analysis of the reasons why sales by way of contractual plans should be so circumscribed, particularly in S. 10.94 to 10.125. We need not repeat the arguments here.

3.08 Mutual Fund Expenses

Sections 7.02 and 7.03 set out the recommendations with respect to management charges and sales loads. Limitations are imposed there on the basis of reasonableness. The reasonable fee can become unreasonable however if other expenses are permitted to be paid under the guise of being something other than a management fee or distribution cost. In effect a mutual fund is nothing but an accounting arrangement when stripped of its management and distribution systems. It should have no other expenses except custodial fees, taxes, brokerage charges, prospectus printing fees and insurance premiums. The Mutual Fund Report S.11.15 suggested that a fund should be prohibited from paying any other expenses. This section does not directly adopt that solution. Instead it relies on provisions to be contained in the regulations. This is similar to an additional requirement suggested in the Mutual Fund Report which would have permitted the regulations to prohibit specific types of expenses. We hope that shifting the provisions completely to the regulations will give flexibility. We do think that the statute should, where possible, suggest criteria for items that are to be contained in the regulations. Accordingly, the section has a reference to expenses necessary to the proper functioning of the mutual fund. This would be distinct from the functioning of the distribution and management companies. Thus the regulations could

permit payment of insurance premiums, custodial fees, brokerage charges, taxes and prospectus printing fees but not the cost of sales literature or quarterly reports used by the distribution company for promotional purposes.

3.09 Books and Records

It is axiomatic that written records form the most reliable basis upon which information can be collected or inspections can be made. The extent of the records to be kept must be co-extensive with the scope of the information considered useful. No doubt records which are useful today may prove useless to cope with tomorrow's problems. Accordingly, the records required to be kept should be detailed in the regulations. Otherwise records would be kept long after their inutility had been recognized. Naturally the records must be open to inspection by the administrator if he is to be capable of any supervisory role. Similar proposals may be found in the Mutual Fund Report S. 8.51, 8.78, 9.47 and 13.44.

PART IV—INVESTMENT RESTRICTIONS

4.01 Permitted Investments

The principal reason for the existence of mutual funds is to provide a collective investment vehicle. The pooling of capital allows diversification of investment, professional management of the portfolio and significant buying power. The investor invests in reliance on the management. It is not the purpose of these proposals to restrict the ability of management to carry out its responsibility for operation of the fund. The aim is to set limits on the portfolio only to the extent necessary to protect the liquidity of the fund and to protect the investor against excessively risky investments.

The benchmark of a mutual fund is the liquidity of its investment to the mutual fund shareholder — the investor is entitled to demand redemption of his shares at any time. To ensure that this right remains more than illusory it is essential that the portfolio investments be highly liquid. Secondly, the holder is interested in receiving a fair price on redemption and on entry so readily evaluable assets are the only ones appropriate for portfolio investment. In an effort to meet these demands the Mutual Fund Report S.12.29 divided investments into three categories — "liquid", "illiquid" and "inappropriate" which we have called "permitted", "restricted" and "inappropriate" respectively. Because investments change their character, so far as liquidity and ease of valuation are concerned, as new or expanded markets open for trading investments, there must be a discretion left in the administrator to categorize any particular type in one category or the other. Basically permitted investments are very liquid, restricted investments have restricted liquidity while inappropriate assets are not really liquid at all. For example, stocks which are not marketable to the public without filing a prospectus are not liquid as a delay would be involved in filing the prospectus and it is even possible that the prospectus might be unacceptable to the regulatory authorities. They would be considered to be inappropriate assets for mutual fund investment. Government bonds regardless of their maturity date, are clearly liquid and would form part of permitted investments.

While the Mutual Fund Report would have defined permitted and inappropriate assets, leaving the rest as restricted, the proposals reflect a slightly different approach. Permitted and restricted investments are defined. All other assets are subsumed within the residual category of inappropriate. The definitions contemplate the administrator being able to designate assets as being in one category or another, which is in accord with the Mutual Fund Report. The result of the change is therefore to prohibit an investment in unclassified assets unless the administrator is first requested to classify them and does classify them as either permitted or restricted.

In the introduction and in the commentary to section 2.07 we explain that the proposals reflect the suggestions in the Mutual Fund Report that there be two categories of funds — conventional and non-conventional. The latter would have greater investment flexibility but more rigid restraints on sales techniques. While no mutual fund would be allowed to invest in assets deemed inappropriate for a mutual fund, the investment restrictions would differ between conventional and non-conventional funds.

If clearly specified in the stated investment practices a non-conventional fund would be able to engage in usual market transactions such as short sales and the purchase of puts and calls written by others. Such investments, while perhaps having a greater risk component, will not cause liquidity or valuation problems for the non-conventional fund, which we

regard as the major reasons for restriction on investment. To solve the liquidity problem the proposals require that non-conventional funds have the same percentage restrictions on the ratio of illiquid investment to net assets as is used for conventional funds, unless the administrator otherwise permits. It has been provided in section 3.03 that non-conventional funds may borrow extensively which will help any liquidity problem if the fund has not borrowed up to the 75% limit. This suggestion of less restricted borrowing but equally restricted investment percentages, unless the administrator otherwise permits, differs from that proposed by the Mutual Fund Report S.12.60 which would have allowed non-conventional funds to invest up to 40% of their assets in illiquid investments as of right. We are not convinced that this wider investment privilege is demonstrably necessary now although it may prove to be desirable when some experience with non-conventional funds has been gained. For the present we believe it would be better to be rather conservative in our approach to investments by non-conventional funds rather than risk exacerbation of the liquidity and valuation problems. We do recognize that, with increased borrowing permissible, the chief problem in restricted investments for non-conventional funds may be the valuation problem. That problem is central to the very concept of redemption which is stressed in these proposals. Accordingly, the proposals permit the administrator to allow a non-conventional fund which satisfies him that the valuation problems have been satisfactorily resolved, to increase its percentage of restricted investments. We doubt that many if any funds will be able to so satisfy him but the proposals are flexible if we are wrong.

To ensure diversification the Mutual Fund Report S.12.74, the OECD Proposals paragraphs 69, 75 and 79 and the U.S. *Investment Company Act* S.12 all provide that only a small percentage of the securities of any portfolio company may be held by the mutual fund and that such securities not represent an unduly large portion of the mutual fund's total assets. The purpose of a mutual fund is to invest in, not to manage, portfolio companies.

The OECD Proposals paragraph 98 would prohibit all mutual funds from effecting short sales because of the unlimited risk possibility. The Mutual Fund Report S.12.60 would only adopt such a prohibition for conventional funds. It would allow non-conventional funds to sell short but the amount of short sales by a non-conventional fund would be aggregated with borrowing and restricted to 75% of the net liquid assets. In the United States the SEC has power to prohibit short selling but apparently has never done so, even for conventional funds. The proposals adopt the middle ground of the Canadian report. The proposals envisage a prohibition against short selling except in securities listed on a recognized stock exchange and effected in accordance with the rules of such exchange. The interrelation between short sales and borrowing has already been recognized in section 3.03.

An option to purchase, i.e. a call, or an option to sell, i.e. a put, may be written by the fund itself in favour of a third party or by another person in favour of the fund. So long as the fund retains in its portfolio securities sufficient to satisfy a call written by it, the possibility of unlimited liability as a result of writing a call does not arise. The securities, if required to be retained, thereby become illiquid however and present valuation problems. The valuation problems can be overcome but the liquidity problems cannot. Also, the general investment community still regards puts and calls as inherently risky. Accordingly, under these proposals these transactions would be prohibited at this time. By allowing the administrator to designate securities as restricted, permitted or inappropriate for mutual fund investment as he sees fit, the necessary flexibility for reconsideration of this position in light of experience is achieved. Until such time as puts and calls become more generally accepted they should be classified as inappropriate for mutual fund investment if written by the fund. It may well

be that a different classification for non-conventional funds may appear appropriate earlier than such a reclassification for conventional funds. This again could be handled by the administrator.

Puts and calls written by others represent a different problem. They are purchased at a fixed price so the maximum liability of the mutual fund is fixed. But they are risky securities in the sense that it is easy to lose the entire investment made in the purchase. Indeed the risk of the market rising or falling is what essentially is being traded. The gamble is too great for the conventional fund. It may be appropriate, to a limited extent, for a non-conventional fund. Again this can be taken care of by administrative designation.

We have adopted the recommendation of the Mutual Fund Report S.12.60 that conventional funds be limited to investing 15% of their net assets in restricted investments. We mentioned above that we propose the same percentage limitation for non-conventional funds. While such a figure is necessarily arbitrary it seems to be in line with current thinking in other jurisdictions.

The Mutual Fund Report S.12.74 suggested that no mutual fund or related group of funds should be permitted to purchase more than 20% of any class of securities of any issuer (except a wholly owned subsidiary of the fund itself which engaged in no activity in which the fund itself could not engage). In the case of voting securities this percentage would be even lower — 10% of the voting securities of any issuer. An exception to these rules would be provided for a fund which invested solely in the shares of another mutual fund, a device necessitated by the complicated tax laws in some jurisdictions. The Canadian Mutual Funds Association originally limited its members to a 10% holding in any class of securities but this proved to be unduly restrictive for some of the larger funds especially with respect to debt issues. It may well be that the 10% limitation on voting securities will become too restrictive. It is something that will have to be watched. If limited voting was prescribed (e.g. cannot vote over 10% of the outstanding voting shares) the 10% limit could be abandoned.

It is possible that even the 20% limit could be too restrictive. One obvious place might be in the case of a first mortgage on real property where the mutual fund might well buy the whole mortgage. Another example is individually tailored commercial paper. Accordingly, our proposals specifically deal with these situations. An examination of the existing investment practices has indicated a number of instances in which the aggregate holdings of related mutual funds would exceed our proposed 20% limit. We believe that this is probably necessary and so long as liquidity is not jeopardized or valuation rendered too difficult, should not be prohibited. The solution adopted in the proposals is to allow the limit to be exceeded but to treat the excess over 20% as restricted investments. The situation is only likely to arise with relatively small issues of securities.

The Mutual Fund Report S.12.74 suggested that no conventional fund should invest more than 10% of its assets in any one issuer. The figure of 15% was suggested for non-conventional funds. We can see no reason for any differentiation in this case so have stuck to the 10% limit. Exceptions for wholly owned subsidiaries and compound funds are provided. The 10% restriction is based on net assets, which discourages borrowing for the purpose of raising the limit. This is necessary in view of the earlier provisions which permit borrowing for any purpose by both conventional and non-conventional funds.

Except for funds on funds, compound funds and wholly owned subsidiaries, where

management and sales charges are expressly limited, there is no reason for a mutual fund to invest in the shares of other mutual funds. Indeed such investments would not only invite doubling of management and sales charges but would also involve a sub-delegation of management responsibility. Our proposed subsection 4.01(8), which covers this point, is a direct result of the Mutual Fund Report.

The Mutual Fund Report S.12.75ff. did not suggest the prohibition of funds on funds but did suggest that limits be placed on the sales and management fees payable. It proposed that funds on funds should be able to invest 20% of their net assets in securities of entities other than mutual funds. Our proposals adopt these recommendations.

Of more difficulty is the recommendation in the Mutual Fund Report that no fund on funds at any time hold more than 3% of the outstanding shares of a mutual fund. While this figure may well be appropriate in the United States we question whether it allows enough flexibility in the smaller Canadian capital market. On the other hand if a fund on funds demanded redemption of all its shares a real liquidity problem could result for the underlying fund in which the fund on funds had an investment of more than 3%. In the 1970 amendments to the U.S. *Investment Company Act* this problem has been obviated by stipulating that no mutual fund should be required to redeem more than 1% of its outstanding shares held by any fund on funds in any period of less than 30 days. This compromise seems to us a desirable one. With that additional provision we have concluded that the 3% limitation in the Mutual Fund Report S.12.81 can be raised to 6% in the Canadian statute. Funds on funds should however be prohibited from investing in other funds on funds and from investing in funds that either are not subject to as stringent regulations as proposed here or are not registered in Canada. Without these limitations there would be the opportunity for easy evasion of all rules for funds on funds. The criteria for investment in underlying funds not registered in Canada have been left for the administrator to decide.

4.02 Prohibited Investments

Mutual funds may trade in a fairly wide variety of securities. They need to have a wide range of choices open to them because of the large amounts of cash they invest. Insiders of the mutual fund complex often have positions with other concerns which are in need of cash. It might be natural to seek help from the mutual fund but the conflict of interest is too clear to require elaboration. Yet one must be careful in limiting the opportunities for investment too broadly. The Mutual Fund Report concluded in S.9.22 that the Canadian economy is closely interwoven and very broad provisions such as those contained in the *Investment Company Act* of the United States would be unduly restrictive.

The Mutual Fund Report S.9.32 suggested a three pronged approach to solve the conflict of interest problems inherent in mutual funds:

a) Introduce a prohibition against self-dealing similar to that now existing in other federal financial intermediary legislation. Under this prohibition would come investments by way of loan to directors, officers and insiders and investments in any form in related organizations. This provision is covered in this section.

b) Introduce specific prohibitions against transactions in which an associate received a fee from the mutual fund, apart from reasonable brokerage charges or fees disclosed in the prospectus. This is covered in this section as well. Reporting is provided for in section 7.08.

c) Apply a general statutory standard on officers and directors to discharge the duties of their offices honestly, in good faith and in the best interests of the organization. This is covered in section 7.07.

In the United States when the *Investment Company Act* was recently amended, a new provision was added to prohibit insiders from dealing in portfolio securities "in contravention of such rules and regulations as the Commission may adopt to define and prescribe means reasonably necessary to prevent such acts, practices, or courses of business as are fraudulent, deceptive or manipulative." Accordingly, in the United States, the range of prohibited self-dealing practices is to be defined by the Securities and Exchange Commission. We prefer to put such prohibitions directly in the proposed statute. The amendments to the *Investment Company Act* also introduced a fiduciary standard for officers and directors which is not dissimilar to that proposed in the Mutual Fund Report and which we have included in section 7.07. The OECD Proposals paragraph 150 envisage prohibitions against loans to insiders and trading by insiders with the fund or its management or distribution companies. It is therefore safe to say that some form of self-dealing provisions are generally agreed to be necessary. How much discretion should rest with the administrator appears to be the real question. The proposals try to limit the amount of administrative discretion but some latitude still remains. For example, the scope of the prohibitions against dealing with associates can be extended by the administrator deciding to enlarge the definition. If the statutory standards proposed are felt to be too stringent they can be loosened with a corresponding increase in the scope of the administrator's discretion. We believe the proposals as drafted achieve an acceptable balance on the discretion issue.

The major part of this section is a direct copy of the approach of similar sections in the *Canadian and British Insurance Companies Act.* A few words have been changed but only where necessary to conform to the definitions used in these proposals and to the structure of the mutual fund complex. There are three basic groups of prohibitions.

The first is prohibited loans. That prohibition runs against individuals only: the directors, officers, their spouses or children and substantial shareholders in the management company, the distribution company or the mutual fund. This parallels the provisions in the *Canadian and British Insurance Companies Act* except that it extends past the fund itself to the other parts of the mutual fund complex. This is simply a recognition of the fact that what is internalized for insurance companies is segregated into separate organizations in the mutual fund complex.

The second prohibition is against upstream investment in any organization that is itself a substantial shareholder of the mutual fund, the management company or the distribution company. This also parallels the *Canadian and British Insurance Companies Act* except that the word "organization" is used instead of "corporation". There is no definition of "corporation" in the *Canadian and British Insurance Companies Act* for the purpose of that section so there is possibly a change of substance here. Substantial shareholding is defined to be the holding of over 10% of the voting shares of the organization in question.

The third prohibition is against investments in organizations that are significantly linked to people or organizations encompassed in the first two prohibitions. A significant link occurs if one individual, such as a director, officer, a spouse or child of a director or officer, or a significant shareholder has 10% of the shares of the organization or if a group has 50% of the shares, in each case whether voting or not. We have here departed slightly from the other

statutory models as we have assumed that the management company or the distribution company may well not have 10% of the shares of the mutual fund but there is still a significant link. Otherwise we have followed the existing models of section 33 of the *Canadian and British Insurance Companies Act.*

It may be that the provisions of the existing federal statutes are either not broad enough or are too broad. If one of them is changed then all should be. We do believe that a mutual fund should be treated like other financial intermediaries in this repect.

PART V—RIGHTS OF MUTUAL FUND SHAREHOLDERS

5.01 Material for Meetings

It is clear to us that holders of mutual fund shares should receive regular information about their fund. We have considered whether reliance should be placed on the laws of the jurisdiction of incorporation or organization to ensure that information is provided. Such reliance might be feasible with respect to incorporated funds. But there are many unincorporated mutual funds that are not made subject to any requirements relating to continuing shareholder disclosure by their jurisdiction of organization. In addition not all incorporating jurisdictions enforce standards of reporting at the level that seems desirable. Accordingly, our proposals include provisions concerning proxy solicitation modelled on those now existing under Canadian and U.S. practice. Since under our proposals there would be no requirement to hold regular meetings at which mutual fund shareholders would have the right to vote, proxy statements would not necessarily be distributed by mutual funds under our proposals with the same frequency that they are by public corporations other than mutual funds. However, when a matter arises as to which the holders of mutual fund shares have voting rights, it seems appropriate that they be informed through a proxy statement. We agree with the view that proxy statements are likely the most important disclosure documents required of an enterprise dealing with the public.

The Mutual Fund Report S.11.33 recommended that mutual funds could deliver lists of shareholders on request but that they should not be required to do so because of the potential abuse of such a requirement. Salesmen of other funds might acquire a list simply as a device to sell shares of the other mutual fund. On the other hand mutual fund shareholders should receive any pertinent information which a fellow shareholder wishes to send to them. The Mutual Fund Report S.11.38 would have approached this result by requiring the fund, on payment of reasonable fees, to disseminate information on demand by a shareholder in connection with a proposed replacement of the management company. Our proposal adopts this approach but with a wider ambit. There seems to be no reason, if the management is reimbursed, why it should not be required to send to shareholders relevant information concerning any matter upon which they will be asked to vote.

One problem that must be considered in regulations of this type is that of the beneficial owner of mutual fund shares whose shares are registered for convenience in the name of a trust company, broker, distribution company or other custodian. There is a danger in these cases that the beneficial owners will not receive the pertinent information. To overcome this problem and to prevent the registered owner from voting in a way which is contrary to the wishes of the beneficial owner the Mutual Fund Report recommended that custodians be required to distribute the pertinent information and that the registered owners should not be permitted to vote without explicit instructions from the beneficial owner. Section 10.02 of our proposals so provides. A similar concept is presently contained in some Canadian incorporation statutes and in Securities Acts, see, for example, S.80 of the *Ontario Securities Act*.

The Mutual Fund Report S.11.38 laid special stress on the rights of shareholders where the management contract was proposed to be changed. It proposed that a right of shareholders to impose a mandatory transfer of a management contract should be created to provide management companies with continuing motivation to perform well, and further proposed detailed procedures to implement the right so that it would be meaningful but

would not be exercised with undue frequency. We support the objectives of the Mutual Fund Report although this and other relevant sections of our proposals deviate considerably from the details of the Report's proposals. Our proposals provide, first, for a requirement to send out a preliminary notice of meeting that a new management company is proposed. Then the shareholders may require that the mutual fund complex, at its own expense, distribute a statement of 1,000 words or less relating to the replacement of the management company. The intention is to give the shareholders advance warning of divergent views if any. This 1,000 word statement may be supplemented by additional material distributed by the complex at the expense of the shareholder (or administrator) demanding its distribution. However it is not intended to distribute mountains of material. Thus the mutual fund complex need not send out at its own expense substantially the same material more than once for any meeting. If any dispute arises over a refusal to distribute there is provision for a court application. This procedure closely parallels sections 128 and 129 of the proposed *Canada Business Corporations Act.* It is consistent with the approach set forth in the Mutual Fund Report although it differs significantly in detail.

The other provisions of this section carry out some of the recommendations set forth in S. 5.66, 6.57 and 6.59 of the Mutual Fund Report. There is no intention to prescribe the procedure to be followed at meetings, including quorum requirements for such meetings of shareholders. It is contemplated that the constating instruments of the mutual fund or the applicable incorporation statutes would contain such requirements.

5.02 Reporting to Shareholders

There are at least three different types of public disclosure currently required of mutual funds. The first type is the disclosure required to a new investor, typically made through a document called a prospectus or an offering circular. The document should introduce the prospective investor to the fund. The second type is the disclosure required by periodic reporting to the shareholder made through a document called an annual report or information circular. That document should tell the continuing investor how well the fund has performed over the time period reported on and any changes which have occurred or which are proposed. The third type is the disclosure required to be filed with the regulatory authorities, open to public inspection in all but rare cases, which provides more complete and up-to-date information on the fund for the benefit of the regulatory authorities and financial analysts.

Because most mutual funds are continually issuing securities, the provincial securities commissions require a new prospectus to be filed every year which is the same periodicity of course as an annual financial report. Accordingly, some funds might prefer to issue only one document which would include the usual annual financial statements that form part of the prospectus. While the Mutual Fund Report S.14.122 saw no objection to such a procedure, and we concur, we recognize that such a procedure may, in practice, be presently impossible due to timing differences between the fiscal year end and the effective date of the current prospectus. Accordingly, we have provided that the administrator may permit the prospectus and the annual report to be one document if the fund so desires and may waive any time requirements necessary to permit a consolidated document.

The Mutual Fund Report S.14.122, the *Investment Company Act* S.30 and existing practice in the industry all support the concept that the administrator and shareholders should receive financial reports at least semi-annually although the OECD Proposals paragraph 54 only require annual reporting. Because of the nature of the mutual fund portfolio such reports can be prepared quickly after the close of the relevant period. In the

United States such reports must be sent to the security holders within 45 days of the date of the report, a provision which appears to have caused no discontent. In both Canada and the United States only the annual report need be audited. There appears to be no reason to send out quarterly reports although it might be helpful to file such a report, if prepared, with the administrator. Often the distribution company finds quarterly reports useful as a sales tool. If this is the basic reason for the quarterly report then the distribution company should pay for the report. Such a provision is recommended in section 8.01.

While the Mutual Fund Report chapter 15 went into great detail regarding the contents of such annual and semi-annual reports, these details are intended to be put in the regulations, not in the statute. We have provided in the statute the basic headings, which are the same as those recommended in the Mutual Fund Report.

The Mutual Fund Report S.6.88 suggested that the auditor's report be addressed to the shareholders, in recognition that the prime responsibility is to them. This section of these proposals carries out this suggestion and provides that the regulations may set out requirements for the auditor's report. It is expected that the administrator will work in conjunction with the Canadian Institute of Chartered Accountants to develop a form of auditor's report which will be informative to the shareholders. Similarly, for the semi-annual report we have required a certificate of the president and chief financial officer which would closely parallel the auditor's report.

5.03 Voting Rights

Corporate law traditionally places considerable responsibility on the directors and requires that they be elected by shareholders. With mutual funds, the situation is often different. Many trusteed funds have no equivalent to a board of directors. With incorporated funds, the board of directors often does little beyond ratifying decisions of the management company and is in some cases elected by the management company through ownership by it of the only issued class of voting shares. The Mutual Fund Report S.6.45-6.49 sets forth in some detail the reasons why the existing practice should be allowed to continue and we have accepted the arguments advanced there. We also concur, however, with the suggestions in S.6.59 of the Mutual Fund Report that voting on management changes and changes in investment objectives or practices should be subject to shareholder ratification. Our proposals differ from the Mutual Fund Report in containing no requirement for shareholder approval of the renewal of the existing management contract every 2 years as we feel it would be a hollow right, putting the complex to unnecessary expense to call the meeting. The real protection is to permit shareholders to require a change of investment management, to require that their approval be obtained for an assignment of the management contract, and to give the administrator power to ensure that the management fees charged do not exceed what is reasonable.

If assignments of management contracts are to be voted on, the question arises how to treat a transfer of control of the management company itself. The Mutual Fund Report S.11.24 and 11.25 stated that such a transfer should not trigger a shareholder approval vote although a vote would be required under S.15 of the *Investment Company Act* in the United States, at least where a direct change of control of the management company occurs. We have adopted, with some modification for publicly traded companies, the approach of S. 15 as the Mutual Fund Report recommendation seems to invite easy evasion. Our proposals differentiate between a "transfer" of control, which would require a shareholder vote if the company was not a publicly traded company, and a "change" of control where no vote would be required unless the administrator so demanded.

The other major problem on transfer of management contracts is what rules, if any, should apply to the payment of consideration for the benefits that the contract confers on the transferee. In the United States there have been indications of the funds themselves paying to the outgoing manager part of the "purchase price", which seems inappropriate. The Mutual Fund Report S.11.22 found no prohibition of such a practice to be necessary and we have followed this recommendation. Normally the buyer pays the seller and we believe this is logical. However, in a recent case in the United States, *Rosenfeld v. Black* (a decision which has resulted in a great deal of criticism in the learned journals and the introduction of proposals for new legislation), the amount paid on the transfer of a management contract was held to be repayable by the old manager to the fund on the basis that a fiduciary cannot profit from his fiduciary relationship by sale of his office. While this may or may not be "good law" we believe it is the type of thing not appropriate for a statute. It is better left for the courts which are capable of setting sensible limits on a case by case basis.

The Mutual Fund Report S.11.15 and 6.59 did not suggest shareholder approval of a renewal of the distribution contract but did suggest approval of the amendment of any such contract. We believe that the most convenient approach would be to put both management and distribution contracts on the same basis and our proposals reflect that belief.

Approval of changes in investment objectives or practices should require shareholder approval as they change the whole basis of investment. This proposal follows the recommendation in S.6.59 of the Mutual Fund Report.

5.04 Delivery of Prospectus

The Mutual Fund Report S.14.61 recommended that the prospectus should be delivered at the time of confirmation of sale unless a summary prospectus had already been delivered and the purchaser had waived the full prospectus delivery requirement. We believe the waiver provision would become a formality unless people genuinely wanted a prospectus, which is unlikely. If the summary prospectus encourages the purchaser to read the prospectus that should be sufficient. We have therefore not insisted on the waiver. We have provided that a mutual fund, on request, should furnish free of charge to any shareholder or prospective shareholder a copy of the current prospectus. This recommendation is even wider than that contained in S.14.122 of the Mutual Fund Report but is consistent with the idea of encouraging more informed investment decisions by mutual fund investors generally. As noted in the introduction to this report, the Mutual Fund Report differentiates between persons who actively seek out mutual funds for investment (the shopping goods segment) and those purchasers of mutual fund shares who were sold mutual fund shares by dint of salesmanship (the unsought goods segment). One aim of the Mutual Fund Report was to increase the number of investors in the shopping goods segment relative to the unsought goods segment. This section is intended to assist in this endeavour.

5.05 Notification of Redemption Rights

The Mutual Fund Report S.10.117 recommended that on prepaid contractual plans a notice of the holder's redemption rights should be sent out if the holder had not made a payment for six months and the prepaid amount had not been allocated in full. While our proposals do not envisage prepaid contractual plans, we believe this concept should be applied to all contractual plans where payments have not been received for six months, unless the plan has been completed in accordance with its terms. Generally the plans are sold by the mutual

fund complex so the distribution company would send out the notice. We have found it difficult to determine who should send out the notice in other cases. To deal with this and other problems, we have included a provision that the complex must authorize or approve any other seller. With this provision in mind it then seems fair to require the distribution company to send out the notices in any event as it can require that the other seller provide it with adequate information so to do in return for approval as a seller.

PART VI—VALUATION, ISSUE, TRANSFER AND REDEMPTION OF MUTUAL FUND SHARES

6.01 Computation of Net Asset Value per Share

The determination of the net asset value per share (NAVPS) of a mutual fund is basic to the whole fund concept as it is that value on which both redemption prices and issue prices of mutual fund shares are based. There are essentially five problems involved:

a) Since it is obviously impossible to effect each sale or redemption at the exact NAVPS at the time the order is placed—this would require valuations each minute—should sales or redemptions be based on a future price or past price?

b) Should there be a different NAVPS for use as a redemption base than that used as a selling base or should only one NAVPS be calculated?

c) How are assets and liabilities to be valued in computing the NAVPS?

d) When should portfolio transactions and sales and redemptions of mutual fund shares be reflected in the NAVPS calculations?

e) How often should the calculation be required to be made?

a) Use of Future Price or Past Price

Until publication of the Mutual Fund Report most mutual funds operating in Canada used "backward pricing". Under that system the NAVPS of a fund calculated after the close of the markets on, say Tuesday, was used as the basis for all redemptions and sales made before the close of the markets on Wednesday. In some cases this price might remain in effect until Thursday, with the price determined as at the Wednesday closing not becoming effective until, say, noon on Thursday. The inherent problem in this practice of backward pricing was that it permitted a skilled trader to invest in a fund on Wednesday afternoon or even Thursday morning at the Tuesday price, knowing the NAVPS would be higher the next day because of the market activity in its portfolio stocks on Wednesday. By redeeming on Thursday at the Wednesday price the trader was assured of a profit, assuming sales charges and redemption fees were covered. With large volume purchases, the sales charges were in fact extremely low with the result that the trader could do better buying the mutual fund than trading with usual brokerage commissions in the stock market.

This type of use of a mutual fund was antithetical to its nature as a long term investment vehicle, both because it permitted knowledgeable persons to profit at the expense of the fund and because the short term trading it encouraged could be detrimental to the fund. However, backward pricing was liked by brokers who were the major sales forces of some funds. Apart from facilitating the kind of trading described above, it enabled them to specify a definite price per share to talk to clients with.

Under "forward pricing" the fund may effect sales and redemptions only at an NAVPS determined after receipt of the relevant order. This minimizes the risk of short term trading in large volumes of mutual fund shares for the reasons explained above. The Mutual Fund Report recommended compulsory adoption of forward pricing and it has since been adopted by the Canadian Mutual Funds Association and in the National Policy Statements of the Provincial Securities Commissions. It is also required in the United States under the *Investment Companies Act.* It has been in use now for several years, appears to work satisfactorily and is accepted by the industry. There might be a slight problem for funds with widespread

operations which receive requests for redemption or for sale very close to the actual valuation time, particularly if one takes the position that receipt by the distribution company is receipt by the fund. Our proposals allow for this by permitting a delay of up to two business days after receipt of the order before the calculation date.

b) Single or Different NAVPS for Sales and Redemptions

The use of a single NAVPS on which to base both the sale and redemption price of shares has the obvious advantages of simplicity and is the almost universal practice in the mutual fund industry today. While a technical argument can be made in support of different valuations to reflect the brokerage and other costs involved in the investment of new money and the liquidation of investments to meet redemption orders, both the OECD Proposals paragraph 164 and the Mutual Fund Report S.13.15-13.25 concluded that separate prices should not be required. In the United Kingdom it appears that different NAVPS calculations are required for sales and redemptions, and a two tier system is permitted in the United States. We have concluded that a single NAVPS is as equitable as a two tier system. Accordingly, under our proposals a single NAVPS scheme would be the general rule with a discretion in the administrator to permit a two tier system for any particular fund.

c) Valuation of Assets and Liabilities

The valuation of listed portfolio securities is not difficult. Funds use either the bid, ask or last sale price. It matters little which one is used as long as the fund is consistent, although it must be acknowledged that the resultant valuations may not always reflect the liquidation value of portfolios since the sale of a block of securities may reduce the market price. This possibility does not lead us to suggest any deviation from market values for liquid assets. However, great differences of opinion can arise as to the proper method for valuing assets of the type included in our definition of restricted investments. The objective must be to have a precise and realistic valuation arrived at by techniques known to shareholders and the administrator. The Mutual Fund Report S.13.44 recommended that no definite rules be set out in the legislation but that there should be a provision permitting the passage by regulation of generally applicable valuation requirements. This suggestion is reflected in our proposals.

d) Timing As to When Transactions are Reflected in NAVPS

In considering when portfolio transactions and changes in the number of outstanding mutual fund shares (due to sales and redemptions) must be included in the NAVPS calculation, the Mutual Fund Report S.13.58 recommended and the Canadian Mutual Funds Association has since adopted what is essentially a one day rule. All portfolio transactions must be reflected in the NAVPS not later than the first computation of NAVPS made after the date of the transaction and capital transactions must be reflected in any NAVPS calculation made more than 24 hours after the time as at which the NAVPS applied to implement such capital transaction is computed. Thus a redemption call made on Tuesday would likely reflect in the Wednesday NAVPS calculation as would a purchase of portfolio securities on the Tuesday although the portfolio purchase could be reflected in the Tuesday NAVPS calculation if the fund so provides in its calculation system and the redemption call could be reflected as late as Thursday. This recommendation would fit more neatly into the regulations so it is not specifically detailed in the statute.

e) Frequency of NAVPS Calculations

Daily calculations of NAVPS are done by most Canadian funds and are required under the *Investment Company Act* in the United States. The vice in a longer period between calculation dates is that, under a forward pricing regime, the investor's money may not be put to use immediately in purchasing fund shares. Some funds only value once every month so the custodian might have the use of the investor's money for up to a month. This raises problems of commingling of money in the hands of the custodian and of paying interest on such money to the mutual fund. On the other hand to require a daily calculation for small funds or funds no longer selling to the public may be adding an unnecessarily great administrative cost. The Mutual Fund Report S.13.71 suggested that valuations be required at least monthly. We prefer the U.S. position of requiring a daily valuation which is the rule followed by most Canadian funds, with a discretion in the administrator to allow for less frequent valuations where it is established to be appropriate. Guidelines for the administrator could be set out either in the statute or the regulations, preferably the latter. Such guidelines should encourage the administrator to allow monthly valuations for smaller mutual funds not engaged in an active sales campaign as well as for funds which have stopped selling to the public or are not listed in the daily newspapers.

6.02 Secondary Marketing

Most mutual funds can be appropriately regarded as pools of money supplied by a large number of investors to be used to purchase a diversified investment portfolio. The investor is something like a depositor except that the value of his interest will fluctuate. He deposits money with the fund and is entitled to withdraw money at any time by redeeming his shares. The amount he may withdraw is determined not by the impact of an interest rate on his original deposit but by the impact of the change in NAVPS between the date of purchase and the date of redemption. Because of the right of redemption, a right to sell the mutual fund shares to another person is not necessary to ensure liquidity for the investor. Nevertheless, where a mutual fund complex imposes sales or redemption charges, there may be a sizeable difference between the effective total purchase price to an investor and the net amount he could obtain in redemption at that time. In that case it may be advantageous to both the investor wishing to acquire and the investor wishing to dispose of mutual fund shares to arrange a direct transfer at a price between the effective purchase and redemption prices. Indeed if this range is substantial, a professional security dealer may establish his own bid and ask prices inside the range of the mutual fund complex.

For example, if the NAVPS is $10, the effective purchase price through the fund complex under usual sales charges in effect in Canada today would be about $10.93 per share. If we assume a net redemption price of $10 a securities dealer could easily offer to purchase fund shares for $10.20 and to sell them at $10.70. The risk to the security dealer in such a situation is small because the dealer can redeem his inventory of shares if it appears that the NAVPS may decline or the inventory is unduly large. Thus he has a stable market to which he may resort if he can find no other willing purchaser. Large scale redemptions by such dealers are a distinct possibility. This could cause a liquidity problem for the fund, which is to be avoided if possible.

There is a second major problem with securities dealers operating as sellers in a secondary market. It is entirely possible that a selling security dealer would not undertake the responsibilities to the purchaser, such as delivering a summary prospectus or judging the suitability of mutual fund investment by the purchaser, which these proposals or the regulations would require of a mutual fund distributor.

The Mutual Fund Report S.13.79 therefore recommended that firms registered to trade in securities be prohibited from engaging in secondary marketing of mutual fund shares, with certain exceptions. Recently proposed provincial legislation would go some way towards adopting this recommendation. It would not be appropriate for inclusion in these proposals directly as these proposals do not encompass the registration of all security dealers operating in Canada. Moreover we feel that the person most interested in prohibiting such a secondary market is the distribution company, which is usually allied with the management company. Accordingly our proposals incorporate a solution which would require the funds themselves to limit the transferability of their shares, subject to exemption by the administrator. This exempting power would be exercised if clearly advantageous to the average investor in the particular mutual fund.

There is no reason to restrict the transferability of mutual fund shares when the mutual fund is no longer issuing to the public. Consequently our proposals would not restrict the transferability of shares of such mutual funds. Similarly liquidity for the investor demands that secondary marketing be permitted if the right to redeem is suspended.

As pointed out above one of the reasons for prohibiting a secondary market in mutual fund shares is to ensure that the purchaser is protected. Some investor protection is in our view necessary even when the administrator has consented to a secondary market or the right to redeem is suspended. Our proposals therefore, provide that, even in these cases, no transfer of a mutual fund share shall be entered in the books of the mutual fund until the mutual fund complex has sent to the purchaser the most recent annual statement. The provision is designed to ensure that the purchaser is at least partially protected.

In this section there is a limited renunciation right when the mutual fund complex is no longer distributing shares to the public if the administrator is satisfied that sales charges above normal transaction costs are being charged by the selling broker. In such a case there is an obvious analogy to a primary distribution with the broker acting more as a salesman than as a secondary market broker otherwise the extra transaction cost would not be justified. It is therefore in our view appropriate to insert a renunciation right although this right is not traditionally available to a securities investor in the secondary market.

6.03 Penalty for Early Redemption

While mutual funds are usually regarded as long term investment vehicles, temptations exist for large investors to use them as vehicles for short term investment. Such investors can often, by purchasing in volume, acquire shares at lower percentage acquisition costs than they would incur if they invested directly in the market. Their investment is more liquid than substantial blocks of listed securities might be. No commissions or fees need ordinarily be paid on redemption. Yet transactions of this type may result in considerable unfairness to other investors in the mutual fund. To avoid these short-term transactions the Mutual Fund Report S.13.88 recommended that purchases made with a view to early redemption should be discouraged. On the other hand there is no reason to impose any restriction on small investors who wish to redeem or against any investor who dies. This section adopts the philosophy of the Mutual Fund Report by requiring the fund to charge a penalty for the early redemption of large blocks. An exception is provided for a case where a retirement plan run by the mutual fund has withdrawals within six months from the date of last contribution. This can easily happen with death benefits and other required payments.

An exemption is also provided for contractual plans that would be otherwise exempt if registered in the name of the beneficial owner. Thus if a distribution company or contractual plan service company had many shares registered in its name as a matter of convenience there would be no penalty for early redemption if the underlying beneficial owner would not have been penalized had he held the shares directly. We considered the situation where large pension funds which have invested in mutual fund shares decide to change their entire investment portfolio. It seemed to us that this problem was better solved by forward planning on the part of the pension fund rather than at the cost of possible liquidity problems to the mutual fund.

6.04 Satisfaction of Issue Price or Redemption Price by Delivery of Portfolio Securities

Occasionally a mutual fund may want to accept securities which would then become portfolio securities, instead of cash on the issue of mutual fund shares. This is most likely to occur when a potentially large purchaser, such as a pension fund, decides to substitute the mutual fund management for current investment management. To liquidate a good portfolio would cost unnecessary brokerage fees. There seems to be nothing inherently wrong in this concept so long as the securities are acquired at a fair price, fit within the investment objectives of the fund and the self-dealing provisions are adequate to ensure that associates of the mutual fund are not pawning off dross onto the fund. Similarly if a large redemption call is made, perhaps because a pension fund decides to withdraw from the mutual fund, it may be advantageous to avoid brokerage fees by permitting the redemption call to be satisfied by the transfer of portfolio securities. The Mutual Fund Report S.13.101 recommended that such transactions were acceptable if only liquid assets were involved and either both parties agreed or, in the case of redemptions, whether or not both parties agreed, the administrator did not object after having been notified. Clearly administrative acceptance is not required where the parties agree as the mutual fund could liquidate those securities if it so chose in any event.

In our view, it is inappropriate to allow a mutual fund to force securities rather than cash on a redeeming shareholder, even if the administrator consents. We are, however, reluctant to leave the matter on the basis that the redeeming shareholder's consent must be obtained, unless some commensurate benefit can be provided to the shareholder as an inducement. Without such an inducement a substantial redeeming shareholder might insist on cash, thereby possibly creating a liquidity problem for the fund which could hurt the remaining shareholders. We can also see a problem for the withdrawing pension fund which wants to change management and not be saddled with investments unacceptable to it. The proposals therefore allow the fund some negotiating room by permitting it to offer the redeeming shareholder half the brokerage fees that would be saved by the fund by delivering securities rather than cash. This should make it possible to conclude some arrangement which is fair to both without forcing on either an unacceptable solution.

6.05 Redemption Time Limit

Investors rely on the right to redeem. It must be protected. Accordingly the right to suspend redemptions should be narrowly circumscribed. The Mutual Fund Report S.13.111 recommended that a fund should be entitled to suspend redemptions if trading is suspended on any stock exchange on which securities representing more than 50% of the total value of the funds assets are traded. Suspension of the redemption right would also be allowed if approved by the administrator. With interlistings being very common it is not clear why the

50% rule is required. An alert administrator would clearly know if the funds were having problems because of exchanges suspending trading. Accordingly, under our proposals suspension of the redemption right would be allowed only with the approval of the administrator.

The investor has a right to be paid promptly when he demands redemption. According to the Mutual Fund Report, the fund complex should be able to pay him within seven days and we have so provided. The fund complex will require that appropriate documentation be delivered to it, which requirement can hold up payment. In order that this not be used as an excuse for any delay on the part of the fund the Mutual Fund Report suggested that a clear statement of the procedures and the material to be furnished should be sent to the investor at the time of purchase. We agree with the concept but it assumes that the investor can find such material perhaps several years later. We believe it would be more satisfactory if the forms required were mailed to the redeeming shareholder forthwith on request and the basic information concerning redemption were sent out to the shareholder at the time of initial purchase. This section carries out that concept.

Redemptions by funds on funds can present a substantial problem to a fund because of the enormous size of the payments such redemptions could trigger. Under our proposals a fund on funds would not be permitted to hold more than 6% of the shares of one mutual fund. In our view it should be sufficient if such an investment can be liquidated over a period of six months. The proposals therefore allow the mutual fund to refuse to redeem more than 1% of its outstanding shares per month if tendered by a fund on funds.

PART VII — GENERAL REQUIREMENTS GOVERNING THE OPERATION OF MANAGEMENT AND DISTRIBUTION COMPANIES

7.01 Bonding and Insurance

It is evident that the officers and senior employees of a mutual fund complex have access to large amounts of money or securities. Custodial arrangements cannot effectively protect against ethical lapses of persons in responsible positions. The premiums for insurance against theft, robbery and embezzlement are costs that a fund simply must bear to guard against unlikely but possibly intolerable losses. Such insurance is appropriate for any institution handling large amounts of liquid assets made up from contributions of many investors.

The problem is complicated by the fact that different organizations require different types of coverage. What might be appropriate for a no-load fund run by a trust company might be inappropriate for a non-conventional fund run by an aggressive management company. We envisage that the regulations could not properly set dollar coverage required but could set minimum amounts. More importantly however, they should contain provisions which ensure that the mutual fund complex has given careful consideration to the appropriate insurance needs. Copies of minutes of meetings of the governing body at which insurance was discussed and dollar amounts agreed on as adequate could be filed with the administrator. The administrator should have authority to require that the insurance be increased. He should also keep under continuing review the types of risks insured against, the categorization of employees for different levels of bonding and like matters. We have provided in the legislation a specific requirement that fourteen days prior notice of cancellation be given to the administrator unless he otherwise directs. All these recommendations are consistent with the proposals in the Mutual Fund Report S.8.40.

7.02 Retail Price Maintenance

Our proposals reflect the recommendation contained in the Mutual Fund Report S.10.72 that retail price maintenance be outlawed. By retail price maintenance we mean an agreement, usually entered into with the distribution company, whereby the party who sells mutual fund shares to retail purchasers does so at a price which includes a sales commission fixed by the distribution company. In the United States the legislation now requires retail price maintenance. The Mutual Fund Report S.10.49ff. explores in detail the reason for the conclusion that the protections derived from such a requirement are adequately replaced by the prohibition of secondary markets and that the prohibition of retail price maintenance will contribute to more effective competition at the retail level in the mutual fund industry. Interestingly, in the letter of transmittal of the 1972 SEC Staff Study, Chairman Casey stated that the "findings certainly suggest there is no compelling public interest in continued retail price maintenance." Recent developments in the United States point to early abolition of the present requirement.

The scope of the prohibition is important. It should be sufficiently embracing that subterfuge is not invited yet consistent with reality. The Mutual Fund Report recognized that sales at fixed prices by supervised employees of the distribution company could not be prohibited. Accordingly, an employee exception, with a definition of the term "employee" tied into supervision and control, has been included. We do not wish to allow evasion by the simple technique of making everyone an "agent" of the distribution company. Accordingly, our proposals would ban the fixing of prices on sales through agents as well as on sales by independent principals. The difficulty with trying to draw a sharp distinction between agents

and employees is exacerbated by the *Income Tax Act.* Significant tax benefits are provided for those in business for themselves as compared to employees. This may lead prospective employers to classify their ''employees'' as ''independent contractors'' where possible. We believe that these proposals should not try to sort out the tax difficulties. Our proposals would permit the adoption of regulations which would expand the definition of ''employee''.

On the other hand there have been attempts in the United States, unsuccessful as of late, to evade similar provisions through the use of *''del credere''* agents—that is principals who are agents in name only. We hope that our definition will not allow such easy evasion.

A further problem arises as to what it is we are trying to prohibit. Essentially the section allows a salesman to split his commission with the purchaser. It is not designed to prohibit a distribution company from insisting on the purchaser paying net asset value plus the commission actually retained by the distribution company. Thus there is an exception for setting the minimum price at the issue price per share plus the part of the sales charge payable to the distribution company which will be kept by that company.

7.03 Sales Charges

There is no more difficult or emotionally charged issue in the whole spectrum of those inherent in mutual funds than the regulation of sales charges. It is obvious that the sale of more shares of the mutual fund is of key importance to the management because the management fee increases as the portfolio assets increase. It may also be important to the existing participating shareholders because a sizeable asset portfolio allows for effective diversification of investment and the percentage management fee usually decreases as net assets increase. At least up to a fairly sizeable asset portfolio, it is probably true that management and existing shareholders want new shares to be issued.

The issue of more shares is often accomplished by the efforts of salesmen who must be paid. When an industrial corporation raises new equity capital by the issue of additional shares, all the shareholders pay for the sales effort, not just the purchasers of the additional shares. This has not been the pattern for mutual funds. Mutual funds must receive at least the net asset value per share on a new issue or there would be an automatic decrease in net equity. To avoid this result the purchasing shareholder is called upon to pay the distribution costs or sales charge. The sales charge currently used by most mutual funds which impose a sales charge has been about 8.5% of the amount remitted to the distribution company. In addition the mutual fund itself may subsidize the distribution process by paying for literature used in the sales process, arranging for reciprocal business or other indirect incentives and through a diversion of part of the management fee to the distributor. The sales load appears large to the investor although the Mutual Fund Report S.10.22ff. noted that it was not possible to come to any general conclusion as to whether in fact the charge was too high or too low.

Exacerbating the appearance of a high sales charge is the contractual plan method of selling shares. Under that system the client purchases mutual fund shares over a period of time, say ten years, on the basis of regular contributions. Contributions may be skipped with no penalty but regularity ensures a growing nest-egg. Obviously most of the sales effort is expended before the plan is established. It is therefore desirable to pay the salesman at that time rather than at some later date. To do so, in view of the fact that regular contributions may not materialize or, if started, may not continue, requires that a high proportion of the first few payments be deducted in order to pay the salesman. This is called a front-end load.

National Policy Statement Number 24 adopted by the provincial Securities Commissions provides that such front-end loads should not exceed 50% of the individual payments made during the first twelve months of the plan. The hard thing to grapple with is the fact that the investor, during the first crucial year, only gets 50% of his money into the fund and working for him.

It is not easy to suggest an equitable solution. If the salesmen are not sufficiently remunerated they may turn to greener pastures so mutual funds will not be made available in areas where they are appropriate or may be sold by less competent individuals.

The Mutual Fund Report S.10.104 concluded that, on the average, the experience under contractual plans was unsatisfactory and that a purchaser who compared the available alternatives would probably not select this method of investment. Yet the Report S.10.106 did not recommend that contractual plans be prohibited. To do so would put mutual funds at a serious competitive disadvantage by comparison with life insurance companies. But the Report strongly endorsed substantive controls over front-end loads.

Since the Report was published, the stock market has fluctuated considerably and the I.O.S. fiasco has rocked the mutual fund industry. The image of mutual fund salesmen was tarnished by I.O.S. The solid performance of mutual funds was hurt by the erratic market. As a result there has been a decline in the direct sales forces of most major mutual funds. We suspect that the number of contractual plans sold has also declined. Changes in the tax legislation along with higher salaries has increased dramatically the demand for registered retirement savings plans, some of which involve investment in mutual funds. No load funds have increased in size, perhaps as a result of more advertising which in turn has increased investor awareness of potential alternatives.

It should also be noted that no load funds, which in Canada are chiefly those established by trust companies, do incur promotional and advertising expenses which contribute to sales but are not funded by sales charges. But no load funds have no direct sales force working door to door. They do send out flyers to their customers. They have employees who counsel investors wishing to purchase fund shares. The costs of the advertising and promotion are likely included as part of the management expenses in one way or another. The Mutual Fund Report commented in S.10.35 that these costs were like sales charges although they are not borne directly by the purchasers.

Sales charges have been regulated in both the United States and Canada for many years. National Policy Statement Number 24 sets out clearly one restriction on sales charges—they cannot in total exceed 12% of the face amount of a contractual plan. In the United States a maximum load of 9% of total payments to be made under a periodic payment plan is specified in the statute itself. While the *Public Policy Report* suggested an immediate reduction to 5% with no front-end load, the 1970 amendments to the *Investment Company Act* indicate that this suggestion was not considered appropriate at that time. In late 1972 the National Association of Securities Dealers did propose a maximum sales charge of 6% unless the fund offered three specific services: reinvestment of dividends at net asset value per share, rights of accumulation and quantity discounts on single purchases. If those services were provided the load could rise to 8.5%.

The Mutual Fund Report S. 10.33-10.36 recommended that, instead of the current pattern of maximum sales charges fixed by a regulatory authority, competition be encouraged so investors would be able to shop for funds with what they considered to be an appropriate sales load. To encourage such shopping it recommended in S.10.38 that educational

programs be financed by Government. In S.10.39 the Report suggested that the media should take on more public responsibility to contribute to the educational process. In addition, the regulation of sales literature was advocated in S.10.37 and expanded on in chapter XIV. Recognizing that such competition would not spring up overnight, the administrator was to be able to fix reasonable sales loads, tailored to the specific requirements of each fund, during an interim period while competition developed. If the fund was dissatisfied with the sales load permitted then an appeal by way of application on originating notice of motion lay to the courts, as outlined in Appendix D.

Basically, this section incorporates the provisions set forth in the Mutual Fund Report. The mutual fund complex, if dissatisfied with the administrator's finding, may ask the Federal Court to judge the reasonableness of the proposed fee directly. This would be a new determination not an appeal from the administrator. In our view the courts are in no better position to judge the reasonableness of sales charges than the administrator, who has a real knowledge of the industry. But courts have a strong public image of independence which engenders confidence in their decisions. If the court desired to have a lay assistant knowledgeable in the technicalities of sales charges assist it, we believe the existing court procedures could accommodate this.

Our proposed statute would confer authority on the federal court rather than on the provincial courts for several reasons. Obviously there is a problem in using the provincial courts in determining which province is appropriate for each fund. More important however, is the fact that under the *Federal Court Act* decisions of federal agencies are reviewable in the federal courts. This pattern is now becoming well established. Hopefully that court will develop considerable expertise as a result of hearing all sales charge applications, an expertise which would not come so rapidly if the courts of the various provinces were used. There is also the precedent of the original jurisdiction in income tax matters, even where an inferior tribunal has heard the matter before.

We envisage that the regulations will set out the matters which the administrator and the courts would be required to take into consideration when considering the reasonableness of sales charges. Such considerations would include the prevailing sales charge levels for other funds of comparable size and investment characteristics, the proposed form of sales organization, the value of other direct or indirect benefits derived by the distribution company or its affiliates and the charges made by other financial institutions for comparable services.

If a court battle over the reasonableness of fees is in progress, fees must still be paid. This section closely follows the recommendations of the Mutual Fund Report S.10.93 which can be summarized as follows:

a) If it is a new fund, the fund can operate on the sales charges the administrator is prepared to agree to until the court determines that a higher charge is reasonable;
b) If the fund is applying for an increase in sales charges the rate previously in effect shall be used until the court determines that the higher charge is reasonable; and
c) If the administrator challenges the existing level of sales charges as unreasonable the rate previously in effect shall be used until the court determines that a lower charge is appropriate.

The maximum front-end load suggested in the Mutual Fund Report S.10.125 for contractual plans was 30% on the first thirteen installments (not including service charges)

and 15% on the next twelve installments with the total charges over the life of the plan not to exceed the basic rate charged on small lump sum sales by the same fund. This is similar to the German legislation but more stringent than the U.S. legislation requires. In the United States, the *Investment Company Act* of 1940 limited the load to 50% of the first twelve payments and such load must be evenly proportioned. The remaining charges or "trail commissions" must be spread evenly over the balance of the plan payments with the total sales charge not to exceed 9%. The 1970 amendments to the *Investment Company Act* left the old provisions intact but introduced an alternative of a maximum deduction of 20% from each payment not to exceed 16% of the payments to be received in the first four years, again with a nine percent total limit over the life of the plan.

The National Policy Statement Number 24 has been mentioned above. It allows a 50% deduction from payments during the first twelve months of the plan and level trail commissions, the total load not to exceed twelve percent of total plan payments. Compared to the German provisions or the recommendations in the Mutual Fund Report, the present maximums in Canada seem somewhat high. It should be noted however, that the National Policy Statement does provide refunds of sales charges if the purchaser withdraws within one year of starting the contractual plan. Thus the full sales load will be refunded if the plan is rescinded within sixty days of its date and only thirty percent of the payments made can be retained by the distribution company as a sales load if the planholder withdraws after the sixty-day period but before the end of the first year. This compares with a rescission right for eighteen months in the United States during which period only fifteen percent may be retained by the distributor as a sales load.

This section of our proposals is really an amalgam of the various systems mentioned above in so far as contractual plans are concerned. It is provided that the distributor must refund all sales charges in excess of twenty percent during the period when a withdrawal right is granted. The maximum front-end load is 50% of the payments made in the first year.

This section also prohibits the mutual fund from paying any commission on the sale of its shares, a provision suggested in the Mutual Fund Report S.13.25. This is necessary where sales charges are limited or an obvious route around the limitation is left open. Payment of commissions by a mutual fund would also be contrary to the concept that the direct payment of sales charges will be shouldered by the purchasing shareholder.

This section includes an important transitional provision for funds in existence at the effective date of the legislation. Their existing sales charges will, in effect, be deemed to be reasonable unless and until later successfully challenged. The section also provides that in determining the reasonableness of sales charges for shares of funds on funds and compound funds the charges made by the underlying fund must also be taken into account. Otherwise an inordinate total sales charge might arise.

7.04 Management Fees

With management fees as with sales charges, the Mutual Fund Report concluded that the most effective regulation would be provided by competition and made proposals designed to encourage competition. One basic proposal was that the sales literature of each mutual fund should disclose that fund's management expense ratio. This is provided for in section 9.04. The Report also recognized that effective competition was unlikely to develop immediately and therefore recommended that the administrator be given authority to determine whether a management fee was reasonable with an appeal to the court if the fund felt the

administrator was taking an unnecessarily restrictive view. In the usual case the court would only be able to say that the management fees were reasonable or unreasonable. It would not determine what was a reasonable fee except where the administrator felt that the existing fees were unreasonable and he could not persuade the management company to adopt what he considered to be a reasonable fee structure. This section adopts this concept.

Management fees today are in fact governed by National Policy Statement Number 7 which permits a fee of up to 2% on the first million dollars of net assets with a decreasing percentage thereafter. This is a rigid formula which does not take into account the differing costs of different types of portfolio management, nor does it distinguish between a single fund and a number of funds under common management. Indeed when this fee schedule was introduced it permitted the payment of management fees higher than those prevailing within the industry. Most newly organized funds have since adhered to this higher management fee structure and a few previously existing funds have changed their management fees to correspond with this structure. In result, it is probably fair to say that the policy statement has had the effect of raising management fees indiscriminately. The individually tailored fee allows more flexibility and is feasible with a single national regulatory authority.

While our proposals reflect the recommendations in the Mutual Fund Report, we wonder whether the fixed, graduated percentage now commonly in use is or is likely to become subject to much competitive pressure. The management fee, including expenses, is always in the order of one percent or two percent per annum. Compared with an eight percent sales load or a fifty percent front-end load the percentage management fee may appear insignificant to the prospective investor although in fact it is extremely important for the long-term investor. That investor is hoping for a return of ten to twenty percent per annum which dwarfs the management fee. His option is likely to redeem or hold, not to worry about management fees. Thus we would be surprised if the administrator will ever be free of the burden of judging reasonable management fees. The system we have proposed does leave the possibility open.

The proposed system could be reviewed, as suggested in the Mutual Fund Report, five years after the legislation becomes effective. Again we envisage the regulations setting out guidelines to be considered in determining the reasonableness of such fees and these might also be reviewed at more frequent intervals. Many of the criteria suggested for sales charges would be suitable for management fees as well as some consideration of the investment research program contemplated.

Another important recommendation in the Mutual Fund Report S.11.56 was that management fees based on performance be prohibited. In its discussion of the recommendation, the Report carefully articulated the arguments against performance fees. In summary the principal points made by the Report, with our comments thereon, are as follows:

a) Performance fees encourage the investment manager to take risks which are inappropriate for mutual funds, especially conventional funds. We feel that this is almost impossible to guard against and that the temptation to engage in risky investment practices is present for all managers who are anxious to perform well.
b) Performance fees seldom have a negative side, the manager collects if he does well but does not pay if he does badly. This can be partly overcome by penalties for underperformance but these penalties cannot be unduly rigorous as managers should always be compensated sufficiently well to persuade them to continue to perform their functions.

c) Investment managers are professionals. The quality of their advice should not be affected by the basis of reward. We doubt that this argument fits with reality, however morally desirable. Many professionals, when faced with a choice between equally demanding jobs, will choose the one with the higher reward. In addition the extra fees to be earned may encourage the professional to work harder.

d) It is difficult if not impossible to judge what is good performance, This is a valid objection and not easily overcome. The Report indicated that comparison with a stock market indicator was not likely appropriate, particularly for non-conventional funds. While it is true that such an indicator is not fully comparable with the investment practices of a fund, it does give a general indication of the way the market is moving. It is certainly imprecise but this does not mean it is not a possible yardstick when coupled with other factors. There are several other indicators available, a combination of which might be appropriate for a particular fund. Surely this is something which can be considered by the administrator in deciding whether a proposed fee scale is reasonable.

e) Rate of return over a relatively short period is not an acceptable criterion for assessing performance and because of the necessity of daily valuation it may be inappropriate to assess the performance of a mutual fund over a longer and hence more meaningful period. We recognize that this argument has much force particularly since the literature suggests that five years may be necessary to establish any true indication of superior performance. We are not certain that this problem can be overcome but we feel that it would be unfair to preclude possible solutions by statutory prohibitions. It seems to us appropriate to rely on the administrator to refuse to accept a performance fee as reasonable unless it effectively reconciles a meaningful judgment of investment performance with the necessity for frequent calculations that will not significantly detract from the accuracy of daily NAVPS calculations.

f) There is no way to charge the fee against new, continuing and redeeming shareholders on an equitable basis. This is closely allied with the previous point and, taken together, they are the most cogent reasons of all for eschewing performance fees. There is no system we are aware of to make the charge completely equitable. However, with this point as with the preceding point, we are loathe to prohibit solely on the basis of difficulty of calculation or difficulties in spreading the burden equitably. Under these proposals the complex must satisfy the administrator of the reasonableness not only of the fee but of its incidence. We feel sure that many fund managers believe that they are equal to the challenge.

On the positive side there are three reasons for permitting performance fees:

a) A continuing investor wants performance. He is likely prepared to reward good performance and may feel that there should be a penalty for bad performance.

b) The manager who attains good performance likely puts more effort and money into research than the manager who does only an average job. Lady luck is not the only factor in good performance. Extra effort should be rewarded.

c) A performance fee will promote competition amongst fund managers. This hopefully will result in an eventual overall reduction in management fees for those mutual funds which do not provide an adequate return to investors.

It is to be noted that both the 1970 amendments to the *Investment Company Act* and the OECD Proposals permit performance fees to be charged by management if they are reasonable. In the United States the reasonableness of the fees may be tested in the courts

while the OECD Proposals require ''close scrutiny by the supervisory authority as to their reasonableness, their method of calculation and the identity of those against whom they are charged''.

This section of these proposals would allow performance fees if the complex can convince the administrator, or failing him the court, that such fees are reasonable.

7.05 Proceedings in Court for Reasonable Management Fees and Sales Charges

Under sections 7.03 and 7.04 the administrator has authority to determine the reasonableness of sales charges and management fees. If the mutual fund, or the administrator in the case of previously established fees or charges, felt that the sales charges or management fees were unreasonable, then a court application could be resorted to by way of original jurisdiction, a remedy similar to that available under the *Income Tax Act* when either the Minister or the taxpayer is dissatisfied with a decision of the Tax Review Board. The court would not set management fees or sales charges, except in cases where the administrator challenged an existing structure; it would simply decide if the fees or charges were reasonable or not. We have adopted wording that we hope will be satisfactory although we realize it would be necessary to amend the *Federal Court Act* in order to carry out our approach. The review of administrative decisions now contemplated under that statute is not broad enough for the jurisdiction suggested here while the original jurisdiction concept under section 24 of the *Federal Court Act* is now limited to taxation matters.

We recognize that it may be difficult for a court to decide the reasonableness of management fees or sales charges. Indeed the problems inherent in developing a satisfactory formula for determining a performance fee are mind-boggling. Accordingly, we believe the court should be specifically invited to appoint an expert to assist it if it so desires. This would not be a novel procedure for a court although it is rarely used except in admiralty cases.

The court procedures envisaged by this section of our proposals are discussed in Appendix D to the Mutual Fund Report. Our proposals are designed, with only minor variations and additions, to implement the recommendations in that Appendix.

7.06 Offence for Non-Conventional Funds to Solicit Outside Canada

Canada's image in the international mutual fund world was severely tarnished by I.O.S. Whether or not Canada should have regulated the I.O.S. funds which were incorporated in Canada but not offered for sale in Canada is irrelevant. Canada was blamed in Europe for not doing so and suffered as a result. Many Canadian funds have been subjected to severe restraints abroad which, in some cases, almost forced them to close out their foreign operations. In our view Canada should not permit domestic incorporation to be a license for the unscupulous to claim Canadian corporate citizenship overseas. That is exactly what the promoters of I.O.S., none of whom was a Canadian, did. It hurts the scrupulous operators who form the vast bulk of the mutual fund industry. We believe we have, under these proposals, set forth a code for all conventional mutual funds which will satisfy the international community and no restriction is imposed upon the foreign sales efforts of such funds. But the international community is not yet prepared to accept non-conventional funds, as the OECD Proposals amply demonstrate. To allow non-conventional mutual funds established in Canada to solicit purchasers in Europe might prolong the suspicions aroused by I.O.S.

These proposals envisage non-conventional funds as an interesting possibility, particularly for specialized types of investment. But in deference to the wishes of the international community we have concluded that they should be confined to operation within Canada until experience here establishes to all concerned that such funds have an appropriate and desirable role to play. This conclusion does not imply that Canadians are entitled to lesser protection than others, for we believe that our proposed statute contains adequate safeguards and that the availability of non-conventional funds will be beneficial to Canadian investors. Our conclusion does reflect a recognition of the possibility that to permit overseas distributions by non-conventional funds might attract regulations that would create problems for all Canadian funds being distributed in other countries.

7.07 Standards for Management

The commentary to section 4.02 summarizes the three-pronged approach used by the Mutual Fund Report to deal with potential conflicts of interest in the operation of mutual funds. This section implements one of the prongs, setting out a general duty of care for directors and officers similar to the statutory provisions recently adopted in corporate statutes in Canada. That standard may well be close to the common law standard as expressed in the *City Equitable* case but the current vogue is to put it into the statute. Statutory inclusion is particularly important for mutual funds where the management might otherwise be able to shield behind the corporate veil of the management company. The definition in this subsection extending the responsibility to persons with either the legal right or the right in fact to control management is a direct result of the suggestion in S.9.32 of the Mutual Fund Report where it was first proposed.

7.08 Detection of Improper Trading

Prohibitions by themselves are effective, even without sanctions, because most businessmen obey the law whether or not they agree with it. But there are those who either do not know the ambit of the law or are unscrupulous. For these few, some detection methods are essential. The thrust of this section is to allow the mutual fund itself to set up a satisfactory detection system of its own design. Failing that, the section has a design which the fund must follow.

The Mutual Fund Report S.9.47 suggested that the management company should be required to report to the administrator any transactions of the fund involving associates other than stock market transactions and other similar situations exempted by the administrator. This would not uncover improper trades in portfolio securities made by insiders. On the other hand, the administrator should not be asked to store reams of paper showing all trades in portfolio securities by insiders. But this section assumes it would not be an insurmountable task to require every insider of the mutual fund to report to the mutual fund all his trades in portfolio securities made within sixty days of a mutual fund trade in the same security. Any trade in portfolio securities required to be reported and not reported would be presumed, *prima facie,* to have been made in breach of the fiduciary standard set forth in section 11.04. This should encourage reporting. In order for the insider to know upon what securities he is required to report the fund would have to send him a trading list. Such a list could easily be prepared annually. The list would also be useful to indicate whether portfolio churning was occurring and should, upon request, be sent to the administrator.

PART VIII — MANAGEMENT AND DISTRIBUTION CONTRACTS

8.01 Content of Management and Distribution Contracts

We need not labour the obvious requirement that management and distribution contracts should be in writing and precisely set out all money to be paid thereunder as well as the services to be rendered. This is the recommendation of both the Mutual Fund Report S.11.15 and the OECD Proposals paragraph 135 and is required under S.15 of the *Investment Company Act.* We have commented under section 5.03 that several specific things should be in the contracts. For the most part, these can be covered in the regulations. Perhaps the most important specific provision we have included here is the requirement for a retiring management or distribution company to cooperate with the administrator in an effort to recruit a satisfactory successor.

We have specifically provided that both the management and the distribution company should pay for services and tangible benefits received from the mutual fund. Otherwise the management fees and the sales charges, which are of crucial importance to both the investor and the mutual fund complex, would not really reflect the total costs involved and might mislead investors. If total costs are shown, comparisons between funds can be made with greater validity. We do however, realize that there are some desirable practices that produce what could be considered to be tangible benefits to the management or distribution companies without any specific payment by them. One example would be the directing of brokerage business to firms that give superior investment advice to the complex. We do not wish to discourage any such practices that are identified as appropriate and have made provision for them to be set forth in the regulations.

The minimum capital requirements were suggested by S.7.44 of the Mutual Fund Report and paragraph 124 of the OECD Proposals. The amount involved could vary as time goes on or indeed as special requirements become obvious for certain funds. Accordingly, the precise numbers involved have been left for the regulations.

8.02 Nomination of New Management Company

Under section 5.03 the shareholders would be given the right to vote on the new management if the management contract is assigned. This right will be set forth in the management contract in addition to the statutory requirements hereunder, a necessary precaution to ensure that the requirements of our proposed statute are enforceable with respect to management companies organized outside Canada, but associated with mutual funds distributed in Canada.

We also propose, as was suggested by the Mutual Fund Report S.11.38, that a shareholder can nominate an alternative to the incumbent management company. This would be an important new right of the mutual fund shareholder, the reasons for which are set out in the Mutual Fund Report in S. 11.28-11.37.

After such a nomination there will be two potential managers with two management contracts which may have significant differences between them. The mutual fund shareholders will then be able to exercise a choice. Obviously under this procedure a prospective alternate—perhaps a competing management company—would be able to have a friendly interest purchase a share and nominate the alternate. The result could be considerable

competition for management contracts, a prospect we view as salutory so long as the fund is not forced to bear the costs of several proxy solicitations. We believe that mutual fund investors purchase their shares on the basis of the existing management. It would follow that the insurgent should only be successful if true dissatisfaction with the incumbent is apparent. To guard against the possibility of needless competition the proposals provide that the insurgent will have to bear his own costs. In addition, the incumbent can only be removed if two-thirds of the votes cast are in favour of removal. This gives an undoubted advantage to the incumbent or at least discourages the insurgent. But the remedy of replacement is only meant for serious cases. In such cases one would expect a substantial majority of the voting shareholders to be required to oust the incumbent, but the incumbent should not vote nor should the insurgent vote shares owned by them or their associates. This novel remedy, proposed in the Mutual Fund Report, is, we feel, worth trying. It must be kept under review.

The distribution company or companies will likely need to be replaced if the management company changes and we have so provided.

PART IX—DISTRIBUTION OF MUTUAL FUND SHARES

9.01 Delivery of Summary Prospectus

In the commentary to section 3.06 we criticize prospectuses in use today and indicate why we concur with the recommendation in the Mutual Fund Report that summary prospectuses be used. This section deals with delivery of the summary prospectus to prospective purchasers. An exemption has been provided in the case of unsolicited customers although this may need to be reconsidered if it is abused. It is very hard to define solicitation (or, to use the statutory terminology "direct contact") in any way which does not invite evasion. We have set out certain activities which in our view should not be considered as solicitation or direct contact for this purpose but have otherwise left the concept undefined. Essentially the objective is to differentiate the shopping goods sector from the unsought goods sector of the market, which was a central concept of the Mutual Fund Report, particularly S.2.41 to 2.51.

We have tried to deal with the situation where investment dealers who are not registered under this Act buy with a view to immediate sale to their clients. In such a case the proper person to ensure delivery of the summary prospectus is the investment dealer. Yet that person would not be registered under the proposed statute and any offence might be difficult to police. The proposals therefore contain a requirement for the mutual fund complex to use its best efforts to require such person to deliver the summary prospectus. In practice this proposal should be sufficient but it will require close scrutiny.

Most of the remedy provisions under the proposed statute appear in Part XI. In this case however we felt the remedy should be made clear at this point. We envisage the mutual fund using its best efforts to require that investment dealers comply with the intent of this section. Only in the absence of such best efforts should there be an offence committed by the mutual fund complex. The investment dealer itself however would be guilty of an offence. It is unlikely that a minor offence by an investment dealer under this section would lead to prosecution. Accordingly, the administrator would have authority to curtail sales to dealers not registered under these proposals if he feels the intent of the prospectus delivery requirement is being evaded.

9.02 Confirmation of Purchase

The Mutual Fund Report S.14.96 attached considerable importance to delivery to a purchaser of a confirmation of purchase setting forth in some detail the destination of the dollars invested and, in the case of contractual plans, the details of any termination fee. Furthermore in S.14.110 the Report recommended that a statement of the rescission rights available to mutual fund investors be included on the confirmation. Receipt of this document would start the toll of the renunciation right, which is provided for in section 9.05 of these proposals.

Similar requirements to those recommended in the Mutual Fund Report were included in Ontario Bill 154. The requirements of Bill 154 particularly as to the inclusion of statements of the redemption and rescission rights on sales confirmations have been strongly criticized by the Canadian Mutual Funds Association. On the other hand, at least with respect to shares sold pursuant to contractual plans a philosophy of confirmation disclosure similar to that recommended in the Mutual Fund Report has been adopted in the 1970 amendments to the *Investment Company Act,* S.27.

We agree that the sending out of a confirmation notice is important to the investor who is likely to reconsider, if at all, on receipt of the confirmation. This makes it important, in our view, that the form on which the confirmation is sent should be seen by the administrator to prevent it being used to confuse rather than to clarify. Resulting confusion is the major complaint of the industry about the inclusion of a statement of the rescission and redemption rights on the confirmation. Many mutual funds now send a "welcoming letter" which might be able to set forth such things as the rescission and redemption rights without confusion. If this were done there would be no need to duplicate the information on the confirmation slip. Subsection (4) is designed to permit such an arrangement. The details of the content and form may be left to the regulations. The statute sets out only a few matters that are so unlikely to change that they can be included directly in the legislation.

The confirmation should be conclusively presumed to be delivered in the ordinary course of mail as recommended in S.14.110 of the Mutual Fund Report. This is of particular importance for the purposes of section 9.05 since, as is noted above, the renunciation right granted by that section runs from the date of receipt by the purchaser of the confirmation. We are aware that it is hard to predict what the ordinary course of the mail may be yet it does give some measure of certainty while allowing for realistic differences in time of receipt by purchasers in remote areas.

9.03 Sales Personnel

Some screening process is necessary to ensure that only ethical persons with suitable background knowledge sell mutual fund shares to the public. This has been dealt with effectively by the provincial securities commissions for many years. They are well equipped to do this because they have local offices conversant with the investment community. It may be that the provincial authorities are prepared to continue the supervision of mutual fund salesmen in which case we would envisage no federal control over salesmen that were licensed by the provincial authorities for trading in mutual fund securities.

There may be situations where federal registration for salesmen would be desirable to allow a select group of experienced men to sell across the country. This might appeal to a specialized fund. Currently the circumstances in which most provinces will grant salesman registration to a person not resident in the province are so narrow that this type of registration is, as a practical matter, unavailable. Hopefully the provincial authorities would be prepared to accept national registration of some salesmen if properly administered at the federal level. Accordingly, federal registration distinct from present provincial registration may have some desirable features. The whole area is one where federal-provincial co-operation would be in the best interests of the investors and the salesmen. The proposals are flexible and designed to be conducive to such co-operation.

The Mutual Fund Report S.16.29 and 16.57 suggested that trust companies and banks, for the sale of funds which have no sales charges should not be required to have registered salesmen. This recommendation was consistent with the position stated in S.14.15 that the absence of a sales charge should be presumed to indicate that purchasers were from the shopping goods segment of the market. The argument is strong if the sales are really unsolicited, a term we have used in this section in distinction to "direct contact" in section 9.01. The registration required therefore is tied to solicitation as recommended in the Mutual Fund Report S.14.25. There may be problems with this approach as it is difficult to know which officer of a bank or trust company, for example, is soliciting purchasers of mutual funds. We have therefore left a residual power to set up categories of both inclusion and exclusion in the regulations.

The Mutual Fund Report S.14.36 and 14.41 recommended that mutual fund salesmen should be permitted to sell insurance policies and to work on a part-time basis. This recommendation can be carried out by administrative decisions under this section and there is no necessity for additional statutory provisions. Similar arrangements are now in force under the provincial regulatory systems.

The Mutual Fund Report S.14.89 recommended that salesmen be permitted to call on residences, a practice prohibited at the time by some provincial statutes. We concur in this recommendation. There is no need of a statutory statement to implement the omission of a prohibition but we felt it should be mentioned here for the sake of completeness.

The Mutual Fund Report S.14.89 recommended that a salesman should be subject to suspension if he counselled switching from other investments into fund securities unless a full explanation of the implications was communicated to the purchaser. Again we feel the administrator can act under the proposed procedure in this section and no additional prohibition is required. Indeed all necessary disciplinary action for abusive sales techniques can be taken under the wide wording of this section.

9.04 Sales Literature

The literature delivered to prospective purchasers is important. Most of us read catchy pieces of promotional material in preference to polished expositive documents. Many annual reports have more space devoted to pictures than to words or figures. It is necessary to have good sales literature. It is important that its message be honest. For all these reasons it is necessary to deal with sales literature within the regulatory pattern. Under section 9.01 we have required the delivery of the summary prospectus at the beginning of the sales process as one method of protecting the investor. Other sales literature is dealt with in this section.

We recognize that legislation should not dictate the content of sales literature but we do believe that appropriate standards should be prescribed. We also believe that certain information should be conveyed to the prospective purchaser early in the selling process and that this can be done through inclusion of the information in the sales literature. Management expense ratios and sales charges are important factors to the investor. We have provided that such amounts should be disclosed in the sales literature first given to the prospective purchaser.

The administrator cannot be expected to clear every piece of sales literature before it is used. No review requirement is imposed under provincial laws and the provincial securities acts do not regulate sales literature. The Ontario Act and several other provincial statutes provide for prohibitions to be adopted in the regulations but no such regulations have ever been passed. Ontario Bill 154 went to the other extreme, permitting only sales literature specified in the regulations. If such literature is dull, the salesman's tongue will rule the day. We prefer the recommendation set out in S.14.79 of the Mutual Fund Report that guidelines be adopted and set out in the regulations. Within those guidelines the distributors would be free to design their own sales literature. The only exception would be advertising by a non-conventional fund which would be purely of a tombstone type, a requirement which can be set out in the guidelines. The guidelines would have to be sufficiently flexible to permit simple letters enclosing other documents or offering to send other documents.

To check that the guidelines are being adhered to the administrator should have the right to require filing of the literature actually used and be prepared to take disciplinary action

if necessary. The Mutual Fund Report S.14.79 envisaged that the administrator could require filing seven days prior to use, if experience has shown that pre-filing is a necessary check for any given fund. This suggestion is reflected in this section of these proposals.

Sales literature is one part of advertising. But advertising can also be done on media with wider audience appeal, such as radio and television. Commercials on radio and television should be subject to a pre-clearance by the administrator because of the difficulty of retracting any inaccurate impressions they may leave. After pre-clearance the advertising should be permitted and we believe that any C.R.T.C. regulations to the contrary should be revised accordingly. We note that television commercials encouraging the purchase of life insurance, which is a directly competitive product to mutual fund shares, are now permitted.

9.05 Renunciation Rights

The point has been made many times that mutual fund shares are usually sold not bought. In various areas of the law it is now becoming common to permit the purchaser of sold goods to repent and rescind without cost, within a specified time after committing himself to purchase. Such is the purport, for example, of section 33 of the *Consumer Protection Act* of Ontario. Long before such rescission rights became common, several provincial securities statutes allowed a purchaser to rescind within seven days of delivery of a prospectus where the prospectus was delivered late. In 1966, following the recommendation in the Kimber Report, the rescission right was reduced to two days after delivery of the prospectus but applied whether or not the prospectus was delivered on time.

In other contexts, one reason for permitting only a very short time in which to exercise the rescission right is the unenviable position in which the seller is placed. The reason has force, for example, with firm commitment underwritings of industrial securities and with the sale of consumer durables. In our view it is less persuasive with the sale of mutual fund shares. The Mutual Fund Report S.14.110 recommended and the OECD Proposals paragraph 206 require a seven day renunciation right on lump sum purchases. We see no reason to abridge that suggested time period. There does seem to be little reason however to allow any renunciation right on a large purchase order, say in excess of $50,000. We make this distinction on the basis of volume both because of the volume discount ordinarily available with respect to sales charges and because of the fact that investments of that magnitude come more often from the shopping goods sector than from the unsought goods sector of the market. Also the availability of the renunciation right to large purchasers would be difficult to reconcile with the penalty for early redemptions to which they are subject under section 6.03 of the proposed statute. This limitation on the renunciation right accords with the Mutual Fund Report recommendations.

With respect to sales of shares on contractual plans, it is generally true that the purchaser comes from the unsought goods sector. For this reason and because it seems inappropriate that such a purchaser should have renunciation rights on payments after his initial payment, it seems appropriate to allow him a longer period after the initial payment to withdraw from his commitment than is available to lump sum purchasers. The Mutual Fund Report S.14.103 recommended thirty days, the *Investment Company Act* now allows forty-five days while Bill 154 suggested sixty days as the period during which the planholder should be able to withdraw without being burdened with any sales charge. We believe that the longer sixty day period is preferable. Accordingly, these proposals incorporate a sixty day rule. That rule must be viewed in conjunction with the reduced sales charge payable on withdrawals subsequent to the expiry of the sixty day period, a point discussed in section 7.03.

Once the basic decision is made to give a renunciation right and the time periods are fixed the question arises as to how much the purchaser should get back. With a mutual fund he can always get back his net asset value so that is no new right at all. Should he also be entitled to receive back any sales or other charges? The Mutual Fund Report S.14.110 so recommended and that recommendation has been adopted. More troublesome however, is the fluctuation in value of the investment during the short time it has been invested. Over the sixty day period allowed on contractual plan renunciations the portfolio value of the fund could change substantially. If it declines in value that decline should, we believe, be charged to the renouncing purchaser. Otherwise, every contractual planholder has a sixty day free ride. That is not the purpose of a renunciation right. It might delay investment by the fund of the money received for the full sixty days, which is not fair to the other shareholders. Accordingly, we believe the downside risk should be borne by the renouncing purchaser.

On the other hand it is not clear that the renouncing purchaser should reap the reward if the fund portfolio increases in value. Consider a purchaser of a contractual plan. He would have sixty days to see if the fund shares rose in value. If they did he could reap the reward without any sales load if no limit were placed on the amount of the renunciation right. We do not think such a possibility fanciful; the *Public Policy Report* acknowledged that similar abuses were prevalent in the United States with respect to the withdrawal and reinvestment privilege. Thus, while the Mutual Fund Report recommended that the purchaser receive back the full value of his investment at the date or renunciation, we have modified this approach in an attempt to be fair but prevent abuses. The section provides that any profit resulting from an excess of net asset value per share would be retained by the mutual fund itself.

We are aware that some contractual plans are sold with completion insurance, an arrangement whereby the complex purchases insurance to guarantee payments if the planholder dies. If completion insurance is taken out it seems unfair to require the premium paid for it to be refunded. We believe that such a refund should only be required if some misrepresentation has been made to the planholder, which is covered in section 11.06. It would not have to be refunded on the exercise of a renunciation right under these proposals. This accords with the recommendations in the Mutual Fund Report.

9.06 Supporting Staff for Sales Organizations

The Mutual Fund Report S.14.49 suggested that provision should be made specifically to permit the administrator to suspend the registration of any distributor which did not have an adequate staff. As our system does envisage registration as of right this must be modified slightly to provide that the administrator may order a fund complex not to issue shares to the public if he concludes that the distribution company does not keep an adequate staff. This remedy is appropriate since the result of an inadequate staff may be undesirable sales practices.

PART X—CUSTODIAL FUNCTIONS

10.01 Custodial Arrangements (Assets)

Mutual funds, by their very nature, have large amounts of liquid assets. The temptation to the unscrupulous is obvious, a fact that is recognized in the regulation of other types of financial intermediaries with similarly large amounts of liquid assets. The resultant risk can be largely met by fidelity insurance. Nevertheless it is acknowledged, in all the major western countries where funds are active, that an established entity must be appointed to take custody of the portfolio assets. In Canada the various banks and ''near banks'' are widely used. Foreign laws could interfere with the realization of securities held abroad. Accordingly, most jurisdictions require that the assets be held locally, much like the reserve requirements presently in force under the *Foreign Insurance Companies Act.* We agree with the concept as modified in the Mutual Fund Report S.8.24—namely that the administrator could, in his discretion, allow the assets to be held outside Canada. This could be essential for a fund operating in several countries.

In some countries the responsibilities of the custodian are very wide. For example, in Germany and the United Kingdom the regulatory structures rely principally on the trustee or custodian. While we concur with the Mutual Fund Report S. 6.60-6.67 that this degree of reliance is inappropriate in Canada, we believe that the custodians have an important function in preventing loss of assets through fraud or physical damage.

The custodial agreement with the asset custodian should set out clearly what the custodian is to do (The Security and Exchange Commission in the United States has considered the matter of sufficient importance to issue sample custodial agreements) especially on requests to release portfolio assets or cash. The custodian should be subject to civil liability to persons damaged if such ''formalities'' are not complied with. Such provisions are better contained in regulations than in the statute because the acceptable formalities may change as computerized systems and other technological advances dictate different surveillance routines and clearing processes. For example, the whole system of issuing share certificates is in question and may be partially or entirely replaced as a method of evidencing share ownership.

The question also arises as to the relationship between the custodian and the fund. The Mutual Fund Report S.8.24 suggested that independence of the custodian was not essential. It also suggested a surveillance role for the custodian in the form of mandatory tattling to the administrator if it had evidence of illegal transactions and voluntary tattling if it had evidence of improper transactions. It is not clear how a related custodian could be expected to fulfill a surveillance function. This section therefore requires independence although the administrator would be allowed to grant exceptions, a provision which may be necessary for funds run by the trust companies and the banks.

Amendments to the custodial agreement are usually not as important as amendments to the management and distribution contracts. Nevertheless they could be. Accordingly, we have adopted the Mutual Fund Report recommendation that the administrator be given fourteen days prior notice of any proposed amendment. He would be allowed during that period to advise the fund that the proposed changes could only be made with the consent of the holders of a majority of the outstanding mutual fund shares.

10.02 Custodial Arrangements (Mutual Fund Shares)

Many mutual fund complexes have arrangements pursuant to which the certificates for the mutual fund shares are not delivered to the beneficial owner but, if issued at all, are held by a custodian, which may be within the complex itself. This is particularly common where multiple purchases by the beneficial owner are contemplated, such as by contractual plan holders.

The two important requirements of such custody arrangements are that adequate records be maintained and that voting procedures be provided where shareholders are required to have a vote. This section constitutes our attempt to address these problems squarely and to produce results that conform with the usual provisions for corporate shareholders where shares are registered in the names of the shareholders and certificates issued. We recognize that share certificates may not be used at all in the near future. Accordingly, we have tried to focus on a share register which we believe will endure in one form or another. The proposals accord with S.8.41 to 8.51 of the Mutual Fund Report.

10.03 Contractual Plan Sponsors

Contractual plans always require special consideration. The organizations which sell and service contractual plans, sometimes called contractual plan sponsors, are no exception to this rule. They should be stable because their services are required over the life of the plan. Fees payable to them for purely service functions should be minimal as they essentially perform only a record-keeping function. They should send cash in quickly and ensure that the fund has adequate authorized shares to service the planholders' requirements. Provisions to enforce these objectives would be very detailed for statutory inclusion and have been left for the regulations.

In the formulation of these regulations the existence of contractual plan service companies should be taken into account. These companies might be forced out of business, with consequent loss to presently serviced planholders, if rigorous requirements were now introduced, which would be retroactive in practical effect. As discussed in S.7.50 to 7.52 of the Mutual Fund Report, these companies perform an essential function in the service provided to investors who purchase contractual plans through brokers or independent sales forces. It is to be hoped that the standards set by the regulations can be flexible enough to encourage existing service companies to build up their assets to the point where they can comply with the recommendations of S.7.54 of the Mutual Fund Report for other contractual plan sponsors. As suggested in the Mutual Fund Report this section of these proposals requires all contractual plan sponsors to register with the administrator.

10.04 Commingling

Commingling is a general problem. We do not wish to suggest that people dishonestly use funds belonging to others as if they were their own. Sometimes, however, a salesman who receives cash from a client will carelessly use it as though it were his own if he has bank deposits sufficient to cover an expenditure but is low on cash in his pocket at that time. We do believe that the mutual fund investor should be protected against such carelessness to some extent by prohibiting commingling in the statute. However, the deduction of sales charges before remitting money received for the purchase of shares, would be permitted in the regulations. This section reflects the recommendations in S.7.44 and 8.64 of the Mutual Fund Report.

PART XI—REMEDIES

11.01 Default of Capital Requirements

In the United States a mutual fund must have net assets of over one hundred thousand dollars before offering its shares to the public. The Mutual Fund Report S.7.25 recommended Canadian adoption of a requirement to the same effect and it forms part of these proposals. The Mutual Fund Report S.7.30 and 7.42 also contemplated minimum capital requirements for both the management and distribution companies of the fund. We contemplate that each requirement would be adopted in regulations promulgated under the proposed statute. What should happen if these requirements are not maintained? Probably the mutual fund should stop issuing mutual fund shares to the public if its net assets have fallen below one hundred thousand dollars. Possibly the redemption right should be temporarily suspended. The Mutual Fund Report S.7.69 recommended that, if any one of the mutual fund, distribution company or the management company fell below minimum capital requirements, the administrator should decide what to do, with the ultimate remedy being a court-appointed receiver. It should be stressed that receivership is only a method of last resort, to be used if negotiations and other attempts fail to achieve an appropriate result. These proposals adopt the concept of the Mutual Fund Report that a receiver is a remedy which can be used in much wider circumstances than merely default of minimum capital requirements. It is therefore also proposed as a general remedy of last resort in later sections of this Part.

If a receiver is appointed then, as mentioned earlier, he will need money to operate the receivership. The first source of this money should be the fifty thousand dollars value of shares placed in escrow pursuant to section 3.05. These shares can however go down rapidly in value and it is necessary to determine who will bear the costs of the receiver in excess of what he realizes on the shares. Also, arrangements are needed for payment of the receiver before the escrowed shares are realized on. In these proposals we assume that the management company, which put up the fifty thousand dollars in escrowed shares, should be the last person paid. To avoid these difficulties the section incorporates a scheme of distribution which may differ from the distribution that would otherwise apply. After payment of the receiver the other mutual fund shares would be redeemed at net asset value at the date of the receivership before anything is paid on the escrowed shares. Only if the expenses incurred in the operation of the receivership had been paid and the other shares redeemed would the holders of the escrowed shares be paid their net asset value per share. The balance, if any, would be divided amongst all the shareholders.

It may also occur that, knowing a problem was forthcoming, the management or distribution company or their associates could redeem shares owned by them before the general public was aware of the impending crisis. The Mutual Fund Report recommended that the court should have the power on the application of the administrator to set aside such redemptions if motivated by knowledge of impending default and such knowledge would be presumed if the redemption were effected within 90 days of the breach of the minimum capital requirements. In our view the ninety day concept is a good one and there should be an automatic setting aside of the redemption, whether or not the redeeming person had knowledge, unless the net asset value per share has risen since the time of the redemption or unless the court orders otherwise. The section reflects this approach.

11.02 Default of Investment Restrictions

The Mutual Fund Report S.12.94 recommended that a default in the restrictions on investment in a single issuer should make available the same remedies as a default in maintenance of minimum capital requirements. The administrator would be notified and, if the problem was not worked out within three days, the administrator could apply to the court to have a receiver appointed. The appointment of a receiver, even as an ultimate remedy, seems drastic but it must be remembered that it is only to be utilized if all else fails. In the United States the remedy appears to be an injunction or other relief in the discretion of the court on the basis of a breach of fiduciary duty. We have adopted the suggestion that the administrator must be informed of any default but have not provided specifically for the appointment of a receiver. Reliance would instead be placed on section 11.07 and the general provisions of law concerning the remedies open to an administrator seeking an order for compliance. We believe the jurisdiction of the court under section 44 of the *Federal Court Act* would permit the appointment of a receiver in such a situation. If this is not so then we would suggest that this remedy be added to the provisions contained in section 11.07.

Section 4.01 includes limitations on the value of the illiquid portion (i.e. restricted investments) of a fund's portfolio. The problem may arise that, without any effort being made by the fund, the value of the restricted investments may soar relative to the value of other assets, or the value of the permitted investments may decline, thus tripping a contravention of the ratio in section 4.01 unless some of the restricted investments are sold. If the value of restricted investments rose sufficiently to have a real impact on net asset value per share then redemptions could be triggered which would seriously affect liquidity and which might be based on inaccurate valuations. A possible solution would be to limit the value which can be placed on such restricted investments in the case of a conventional fund to no more than twenty percent of total assets, ignoring any excess in value above that amount. To do so would distort the true value of the portfolio and lower the calculated net asset value per share below its actual value. This, in effect, might put a penalty on the redeeming shareholder, thereby making redemption less likely, and give a premium to new shareholders, thus encouraging sales. A secondary problem might arise in that, if the illiquid portion were unduly held down in value, the pressure for a secondary market in shares of the mutual fund would increase. This section therefore allows the administrator to intervene in the formula pricing under such circumstances to ensure that peculiar results do not obtain. We have also given him a right to suspend redemptions in such a situation. He would be free to apply to the court for any appropriate remedy, even a receivership, if the need arose. These remedies are considerably broader and more flexible than those proposed in S.12.94 of the Mutual Fund Report.

11.03 Ceasing to Issue

Contractual plan holders are long-term investors. They pay a heavy sales load at the first with the expectation that the fund will continue to operate. Stability is therefore essential. The requirement in section 3.07 for a high net asset value before a fund sells contractual plans would contribute to stability. But there is no way to guarantee that a fund will continue to operate. There is no system of reserves as there is for insurance companies. Indeed, no such system would be appropriate. Yet the contractual plan holder would suffer loss if part way through the expected life of his plan the mutual fund ceased to issue mutual fund shares. Unless the plan could be switched to another fund without attracting additional sales charges, his investment would be in jeopardy. The Mutual Fund Report S.8.59 recommended and this section provides that he should have the right to demand back that part

of the sales load in excess of what would have been paid under a level load plan. How realistic is this solution however ten years after he entered into the plan if the contractual plan sponsor is also out of business?

To see the magnitude of the problem, assume a twenty-one year plan in which the planholder contributes one thousand dollars per year. Using an 8.5% overall load the total sales load payable will be $\frac{8.5}{100}$ x 21 x 1000 or $1,785 of which, using the maximum rate permitted in these proposals, $500 would be paid in the first year with the other $1,285 spread evenly over the next twenty years of the plan. Over the next ten years the load would be $642.50 so that if the fund ceased to issue shares at the end of the eleventh year the planholder would have paid a total load of $1,142.50 on $11,000 invested. Had he instead purchased $11,000 of mutual fund shares at a sales charge of 8.5%, the total charge would have been $935. The excess load is therefore $207.50, a relatively small amount considering the total contributions, less than two percent. On the other hand, if the fund collapsed after his sixth year he would have contributed $6,000 including a load of $821.25 which is some $311.25 in excess of what he would have paid on a level load, being more than five percent of the total amount contributed. Thus the importance of the remedy suggested in the Mutual Fund Report diminishes as the plan ages.

If the remedy were to be really effective it would be necessary to ask the distributor to set up a reserve against the contingency. This would negate the whole concept of a front-end load. We believe that, on balance, the cure may be worse than the disease. Under section 9.05 of the proposed statute the planholder would have the right to withdraw at no load for sixty days. In the circumstances, we have not included a reserve requirement in the proposed statute to protect the rights of the planholder. The statutory liability together with the capital requirements designed to ensure solvency of the distributor should be sufficient.

Another question is whether the potential liability of the distributor should last indefinitely. The mutual fund shares might become unavailable for reasons beyond the distributor's control. Also, as noted above, the importance of the remedy diminishes as the plan ages. We have concluded that it is fair to place a relatively short time limit on the additional remedy. The distributor cannot be expected to bear the risk forever, although there is nothing to stop him from obtaining a right over against secondary distributors for any liability that might be incurred in such event. Under this section the right to demand the return of sales charges would therefore terminate after five years, even if the fund ceases to issue. A better remedy, suggested in the Mutual Fund Report S.8.60 would be to find another mutual fund which would complete the plan in accordance with its terms. If the original fund is no longer selling securities its distribution company is unlikely to function so far as that fund is concerned. The plan custodian has the chief continuing interest in such event. If an appropriate new fund is found, the distribution company will probably be able to agree with the planholder that no sales charge is refundable. We assume the contract between the contractual plan custodian and the distribution company will take cognizance of this obligation, perhaps by imposing on the distribution company an obligation to reimburse the custodian for costs incurred in finding a new mutual fund up to an amount equal to the minimum capital of the distribution company.

11.04 Use of Confidential Information

In the commentary to section 4.02 the three-pronged approach taken to insider liability in this statute is explained. That section and section 7.08 contain restrictions equivalent to the self-dealing prohibitions in the federal *Investment Companies Act* and in other Canadian

statutes regularing financial institutions and to the insider trading provisions for industrial companies, modified in each case to reflect the differences relevant in the mutual fund situation. These modifications are significant with insider trading since insider trading provisions for industrial companies concentrate on dealing in the corporation's own securities rather than in its assets while the reverse must be the case for mutual funds. With mutual funds having at their command large amounts of money to invest, foreknowledge of the direction of the investment can be a sizeable benefit to the insider if he trades in portfolio securities. Thus the focus in section 7.08 is on insider dealing with securities of the type held in the mutual fund portfolio.

This section concerns itself with remedies for the breach of the self-dealing prohibitions. The Mutual Fund Report S.9.41 and 9.57 recommended a wide range of remedies with the court fashioning the remedy to suit the case at hand. We favour that proposal and it is contained in the general remedies section. Similar broad legislation in the United States has permitted a wide variety of suits to be brought where abusive insider trading was alleged, such as the *Texas Gulf* and *Douglas Aviation* transactions. The provincial legislation in Canada to date has not resulted in any insider liability being imposed by the courts at the instance of an allegedly aggrieved investor. Its effectiveness is therefore an open question. However, some commentators have wondered whether its reach is as broad as that of the comparable legislation in the United States. It certainly does not appear to extend to ''tippees''. Indeed the Ontario Minister then responsible for securities legislation called it ''impotent'' in 1969. As a result the proposals adopt a more comprehensive civil liability section based on transactions arising as a result of any breach of confidential information.

The person really injured by such reprehensible trading is the fund itself not the other party to the trade. The Mutual Fund Report recognized this and felt the old rule, commonly known as the rule in *Foss v. Harbottle,* should be altered to permit any shareholder to commence the action where the fund did not do so or was not diligent in its carriage of the action. If the fund wished to sue then that would be the better alternative. Again this recommendation is reflected in the section dealing with general remedies.

11.05 General Right to Bring an Action

It may not be clear who is entitled to bring any action on behalf of a mutual fund, particularly an unincorporated fund. This section contains general rules to clarify this point consistent with S.9.41 of the Mutual Fund Report. It may also be necessary to add some provision to the *Federal Court Act* to correspond to the provisions contained in this section. It may well be that the person who brings the action will himself not diligently prosecute the action. To prevent such an abuse we have provided that the administrator can ask the court to let him take carriage of the action if the original plaintiff is dilatory.

The opening lines of section 11.05(1) are designed to avoid an interpretation similar to that arrived at with respect to section 99 of *The Business Corporations Act* (Ontario) in *Farnham v. Fingold,* (1973) 33 D.L.R. (3d.) 156, namely, that the section lays down the only way in which a derivative action may be brought.

11.06 Prospectus Liability

This section provides, in language similar to that of existing provincial securities legislation, that every purchaser of mutual fund shares shall be deemed to have relied on the statements made in the full prospectus. This is in contrast to the concept of non-reliance on the summary

prospectus. A similar scheme has recently been adopted in the United States. This section goes on to provide for liability if it is subsequently discovered that the statements in the prospectus are materially false or misleading. The primary model used here is Ontario Bill 154. The only basic change we have made is to allow a rescission right up to 90 days after the misstatement has become known. The right in Ontario was proposed to be limited to ninety days after prospectus delivery. The change is made because of our concern that errors may not become known in that period. Bill 154 imposes the additional remedy of damages against the responsible officials of the fund for loss occasioned to the purchaser. In our opinion this should be limited to the situation where rescission or redemption has not proved to be an adequate remedy and this section so provides.

11.07 General Remedies

This section contains four general remedies, two of them common to this type of legislation. One simply makes any violation of the proposed statute an offence. The other is similar to the present provision relating to orders for compliance in force in most provinces in Canada. The two less common remedies are for the administrator. One permits him to call a shareholders' meeting at any time he thinks appropriate although no vote binding on the fund could be required at the meeting unless the matters discussed were matters as to which the shareholders had voting rights, either under this statute or under the laws of their jurisdiction of organization. In spite of the possible lack of voting rights the calling of a meeting would provide an opportunity for the views of the shareholders to be expressed. The other administrative remedy permits the administrator to seek the appointment of a receiver and manager at any time he believes that to be in the best interests of the mutual fund shareholders. The appointment would, of course be obtained only if the court agreed that such action would be in the best interests of the shareholders. Such interest might be shown by the shareholders agreeing to such a course of action at a meeting called by the administrator. As mentioned earlier, this approach implements recommendations in the Mutual Fund Report such as S.7.69.

11.08 Appeals

While the provincial securities statutes contain wide rights of appeal from decisions of the administrative authorities, our impression is that these rights have been little used. We concur with the analysis in S.16.78 of the Mutual Fund Report as to why certain administrative decisions in the securities area are ''in fact unappealable''; indeed, we feel that the problem is of wider application than that section indicates.

In spite of these concerns this section incorporates a right of appeal. It may be that, as the various persons and organizations concerned with regulatory problems become more accustomed to dealing with the regulatory authorities, appeals to the courts will become more frequent. Within reasonable limits, we would consider this to be desirable.

11.09 Remedies for Prohibited Contracts

We have considered the question of whether a contract entered into in violation of the statute should be void or voidable. We have concluded that the legal doctrine of ''illegality'' under which a contract is void in the sense that the courts will allow no remedy for its breach has no place in a regulatory statute such as the one proposed. We do think that a contract entered into in violation of the self-dealing provisions should, with court approval, be voidable at the option of the mutual fund and that the court should be able to fashion any other remedy that is appropriate. Other contracts, such as those in breach of investment restric-

tions should be valid if executed or if an innocent party would be hurt if they were not executed. The appropriate penalty in such an event is to subject the person authorizing the prohibited act to a criminal or civil sanction.

While we believe that any wilful breach of a statute should be an offence as set forth in section 11.06, the question of civil damages is more difficult. In general we believe that a court should be permitted to award damages in a civil action to any person who has suffered loss as a result of the breach of this statute by another. But there are situations where such a remedy would not comport with common sense. Accordingly, we have included a specific provision setting forth the general rule but allowing the court to modify it to fit the circumstances of the case.

PART XII—THE AUDITOR AND SURVEILLANCE

12.01 The Auditor

In Canada as elsewhere much reliance is traditionally placed on the auditor to verify compliance with legal requirements by business enterprises. Disclosure is the core of modern securities regulation and it is the auditor who verifies the adequacy of disclosure at least so far as financial information is concerned. That this section goes somewhat beyond the traditional provision in the extent of rights and responsibilities imposed on the auditor reflects an acknowledgement of the importance of the auditor's role rather than any disagreement with other statutes.

While disclosure is the core of securities legislation, the regulatory authorities have implicitly or explicitly indicated that it is not alone sufficient. In the mutual fund context, the power to reject a prospectus has long been used by the provincial securities commissions as the basis for the imposition of substantive requirements, including many requirements proposed in the Mutual Fund Report. The *Shoppers Investment* and *Wocco Investment Limited* decisions reported in the October 1972 and February 1973 bulletins of the Ontario Securities Commission may reflect administrative willingness to extend the use of this power. In the context of mutual funds, the comparative lack of sophistication of many investors and the great liquidity of assets accentuate the need for substantive rules. That accounts for many provisions of the proposed statute. Yet disclosure remains of fundamental importance; indeed, since many substantive rules may be of little value without effective techniques to ascertain failure of compliance, it may be of even greater importance with mutual funds than in other contexts.

The Mutual Fund Report considered various techniques to ascertain failure of compliance with substantive rules and concluded that the auditor had a vital role to play. This conclusion was influenced by the belief that any alternative would involve a high degree of direct regulatory involvement in mutual fund affairs and the tenet, with which we fully concur, that such involvement should be avoided except to the minimum extent necessary.

The reason for reliance on the auditor to assist in the surveillance functions is clear. The fund auditor, or an industry auditor appointed by a self regulatory association, is admirably suited to such a role. Such an auditor is the only outsider who regularly conducts a complete review of the mutual fund records. In the case of the fund auditor, such a review is done in order to report to the shareholders on the financial position of the fund. Traditionally the auditor does not question management decisions, he simply reports on them. There is no intention to change that position. There is no intention to interfere with management flexibility to make investment decisions. What is intended is that there should always be an auditor, that the auditor should be independent of the management of the mutual fund, that the auditor should have impressed upon him his duty to report clearly to the shareholders what has transpired during the period under review without pulling punches, that he be required to report, at least to the administrator, any evidence of illegality and that he be encouraged to report any evidence of impropriety.

It has been recognized increasingly over the past several years that auditors must be independent of the entities on which they are reporting except in the case of small family concerns where no outsiders are involved. The situation is slightly different with respect to mutual funds because of the presence, in the usual case, of a management company and a distribution company. It is those companies of which the auditor need be completely

independent. Independence of the fund itself is much less important. Indeed the Mutual Fund Report would have permitted the auditor to purchase shares in the fund. We disagree with the Mutual Fund Report on this point because investment by the auditor in the fund might appear to interfere with his objectivity in evaluating valuations placed on assets, which would be part of his auditing function.

At the present time National Policy Statement Number 3 contains much broader restrictions on the auditor's involvement than suggested in these proposals but subject to a qualification which, in effect, allows the auditor to beneficially own securities under a trust which provides he cannot vote the securities and has no say as to whether they are bought or sold. We understand that the Canadian Institute of Chartered Accountants is actively considering the reach of the prohibitions to try to make them fair and realistic. It may be that as a result of that consideration this section may require amendment. It now carries out the proposals in S.6.76 of the Mutual Fund Report with the additional requirement that no shares be held in the mutual fund itself. We have not extended the prohibition to certain associates as was recommended in S.6.77 of the Mutual Fund Report as the reach of the term ''associate'' would be very broad indeed.

The appointment of the auditor for incorporated funds is dealt with in the statutes under which they are incorporated. We do not intend to trench on this jurisdiction. The only addition we propose to make here is to provide that the administrator may appoint an auditor where there is no duly qualified auditor in office. Qualified in this context would include independence. We have provided that the administrator may require shareholder approval of any change in the auditors.

The Mutual Fund Report S.6.88 recommended that the directors should be permitted to remove the auditor without penalty on fourteen days notice subject to a right in the administrator to demand that shareholder approval be obtained before such removal. Most corporate statutes now contain a provision whereby the incumbent auditor cannot be removed without a chance to be heard. We are concerned that the recommendations we make here not conflict with existing corporate law. It is true that many funds are not incorporated. But provincial standards for auditors of unincorporated associations will presumably develop, just as they have for incorporated ones. We have therefore not included any dismissal provisions in the proposed statute. The administrator would however have authority to require shareholder approval of the appointment of a new auditor.

We have proposed in section 5.02 that the auditor's report be addressed to the shareholders. This provision would not conflict with any statutory provisions requiring that the report be addressed to the directors; in such event it could be addressed to both. We have also recommended the inclusion in the auditor's report of his opinion as to whether the financial statements present fairly the financial position of the fund. Many people believe that the auditor prepares the financial statements, rather than just reporting on statements prepared internally. Indeed, in practice, the auditor may prepare the statements but, if he does, it is as surrogate for the directors. As surrogate for the shareholders he merely reports on statements. The presently used form of unqualified certificate appended by auditors to most financial statements is uninformative. We believe a narrative report may be appropriate for reporting to mutual fund shareholders. The detailed contents of the report should be specified with sufficient particularity in the regulations to enable any auditor to see what was required. The regulations would have to be worked out with the help of the Canadian Institute of Chartered Accountants to ensure that they were practical.

We have not proposed a Financial Disclosure Advisory Board similar to that suggested in recently proposed provincial securities legislation. We believe that the Canadian Institute of Chartered Accountants has proved able and willing to provide authoritative and expert guidance on specific issues. Of course, if the Institute does not work out as an adviser then such a Board could be an alternative.

The other aspect of reporting, which is more controversial, is the suggestion in the Mutual Fund Report S.6.88 that the auditor report improprieties and illegalities. Such mandatory reporting of suspected illegalities puts the auditor into the role of a policeman, a role he may not particularly enjoy. Nonetheless given our view of the mutual fund shareholder as a mere depositor and the auditor's expertise in such matters it is only natural that he perform such a function. At least for an interim period we believe a mandatory reporting scheme should be tried.

12.02 Surveillance by the Asset Custodian

In section 10.01 we noted that the asset custodian should be a substantial financial institution. While it has a limited role to play in mutual fund operations it does have a proximity to the liquid assets that no other person has. Accordingly, it seems logical to expect that the asset custodian may recognize illegal or improper transactions before anyone else does. This section accordingly would impose a positive obligation on the custodian to report illegalities to the administrator. As with the auditor, the proposals do not require but permit the reporting of improprieties, whether definite or suspected. These provisions are in conformity with S.8.24 of the Mutual Fund Report.

12.03 Surveillance by the Administrator

It is evident that the administrator must also play a role in the surveillance of mutual funds. That role should be at two levels—a right to inspect at any time the workings of the mutual fund complex and a duty to investigate if it seems probable that some contravention of the statutory scheme set forth in the statute has occurred. Much of this section incorporates language from the *Ontario Securities Act,* as it is the most clearly analogous precedent. It may be that some of the provisions could be shortened but we felt completeness at least at the proposal stage would be helpful.

It may be that a self regulatory association could carry out a large part of this surveillance role. We would welcome the advent of such an association. The existing association, the Canadian Mutual Funds Association, may still not satisfy all the requirements of the Mutual Fund Report to fulfill the desired role. The writers of the Report concluded that it did not do so at the time the Report was published. If the pre-conditions set forth in the Mutual Fund Report S. 19.36 are satisfied, we believe the administrator should be entitled to delegate much of his surveillance responsibilities to the self regulatory association in so far as members of that organization are concerned. It may be that the self regulatory body would not wish to accept such a responsibility. If it declines to do so then the administrator would be forced to retain his surveillance role. We would hope the self regulatory body might accept the challenge.

While we have not generally set out the various arguments put forth in the Mutual Fund Report, we do feel that the major points with respect to the role a self regulatory association is expected to perform are worth repeating. The Canadian Mutual Funds Association has performed a useful service in the establishment and improvement of a salesman training

program. In addition, that Association developed an audit inspection program, which has now become a statutory requirement under the provincial Securities Acts, and a questionnaire routine. These proposals adopt the questionnaire concept.

A self regulatory association could be involved in three major areas at least. One is the setting of standards for entry into the industry of salesmen, mutual funds and management and distribution companies. It is obvious that the regulatory authority must have ultimate control in this area or the entry policies could become exclusionary devices based on erroneous principles. Nevertheless there is a large role here for any industry association, at least in recommending standards, running courses and criticizing existing practices of the administrator. This role would be possible under our proposals.

Secondly the association could usefully investigate its own members where deemed appropriate. Such a role would ease the burden on the administrator and might well be more efficient than the administrator could be. One example presently operating is the market surveillance group of The Toronto Stock Exchange. We have allowed for a similar role for a self regulatory body in this section.

Thirdly, the association would concern itself with the acceptable level of service that the management or distribution companies should give to the mutual fund with which they are associated. Recently the industry association (NASD) in the United States has recommended reduced sales charges for distribution companies that perform only minimal ongoing services. Under our proposed statute the ultimate decision would be left to the administrator or the courts but the force of the industry association making the suggestion has an impact on the members of the industry. Again such a role can be played under these proposals without any statutory provisions.

12.04 Surveillance by Shareholders

Most corporate law statutes contain provisions whereby a specified percentage of the shareholders can initiate an inspection of the affairs of a corporation. The proposed *Canada Business Corporations Act* has used a 5% shareholder inspection right where specific forms of inappropriate conduct appear to have occurred. The Ontario Act uses one shareholder as the basis, if he can convince the court to allow the inspection. Both statutes allow an inspection if the shareholders so decide in general meeting regardless of the grounds. We have adopted a concept similar to that contained in the proposed federal statute but reduced the percentage to one percent because shares of a mutual fund are generally very widely dispersed. This may be partly unnecessary as far as incorporated funds are concerned in view of the provisions in the incorporating statutes. It is however necessary for trusteed funds.

PART XIII—ADMINISTRATION

13.01 The Administrator

We comment in the introduction to this report on the importance of the administrative role. If the proposed statute is adopted, its success will be dependent on the appointment of a highly qualified administrator and on his being permitted to pick highly qualified staff. This section does not try to do any picking for him. It does allow for the possibility of regional offices which we think are essential. If an administrator or his deputy is available locally he is more likely to be consulted. Additionally we might add that there is no magic in forcing the administrator to sit in Ottawa where, so far as we are aware, no major mutual fund has its head office. If local deputy administrators are established it might make the administrator redundant if he did stay in Ottawa. It may be that he should establish the central office in one of the mutual fund centres.

We have not attempted to prescribe the civil liability, if any, of the administrator. The provincial Securities Acts contain sweeping provisions precluding any action without the consent of the Minister against persons administering those Acts. That has not been the pattern in federal statutes to date. For example, there is no reference to the liability of the Superintendent in the *Canadian and British Insurance Companies Act* except in one specific case when he has control of certain assets. Otherwise any liability would be covered by the *Crown Liability Act.* We have followed the existing federal practice.

13.02 Publication of Administrative Decisions

One of the most difficult problems connected with the operation of a regulatory agency is how to ensure that members of the public, including new members of the industry regulated, can find out how the agency in fact administers the statute. Long experience is one route but should not be the only one. The obvious answer is to publish all decisions, directions, orders and rulings of the administrator with the reasons on which they were based together with a statement of the relevant facts. But that is a tall order indeed.

There are relatively few people interested or likely to become interested in the administrative workings of this Act. Publication expenses might be, on a per copy basis, very high. These proposals suggest as an alternative the publication of an index to the administrative decisions, a requirement now contained in the *Administrative Procedure Act* of the United States. We would envisage this index to be set up both by section of the statute and regulations (much like a statute citator) and by subject matter. The actual administrative rulings, the reasons and the facts under any particular heading would be available on request and on payment of a fee. This would be done by photocopying from the files involved.

A second problem relates to policy statements and their interrelation with regulations. We believe that policy statements should be published. We further believe that, where a policy has in fact been developed, it should become the subject of a policy statement. We do not believe that policy statements should be treated like regulations which are passed by the Governor-in-Council. Policy statements should be flexible in the sense that they can be varied for particular mutual fund complexes as exigencies may arise. If it be decided to have a maximum custodial fee, for example, that should be in a regulation not in a policy statement. In that way the elected arm of the government keeps reasonably direct control over the administrative arm, which we view as desirable. As we believe that this accords with existing Canadian jurisprudence we do not feel that we are breaking new ground.

Our hope is that the administrative practice established under the proposed statute would provide relatively clear published guidelines as to the requirements applicable to mutual funds and their associated management and distribution companies. We trust that the administrator will publish proposed policy rulings and provide an opportunity for discussion prior to their adoption. We cannot too strongly deprecate the adoption of new policies on an *ad hoc* basis without opportunity for prior consideration or discussion by those affected.

13.03 General Relief and Transitional Provisions

We believe that a regulatory statute such as we have proposed needs flexibility without subjecting the regulated industry to a blanket discretion which involves continuous checking with the administrator. We also believe the statute should permit the administrator to issue advance rulings, a system now adopted by the Department of National Revenue with respect to questions arising under the *Income Tax Act*.

With the introduction of a statute regulating an existing industry there must be both general prospective exempting (but not including) provisions plus a transitional provision period during which the administrator can tailor the statute to fit the industry until the industry has time to adjust to the statute. This follows the recommendation in S.7.20 of the Mutual Fund Report.

13.04 Regulations

The specific list of matters made subject to regulation by this section is obviously not complete. It could be filled out as definite statutory requirements emerge if that is felt to be necessary. This list only represents an absolute minimum of specifics with a wide general clause. This section includes a pre-publication clause which we believe essential in the regulation of so complex an industry. It is modelled on a similar clause in the proposed Canada Business Corporations Act.

APPENDIX

THE CONSTITUTIONALITY OF FEDERAL REGULATION OF MUTUAL FUNDS

By PETER W. HOGG

Purpose and scope of this Appendix

The proposed mutual fund statute would subject nearly all mutual funds to a scheme of national regulation. It would apply (with some exceptions) to mutual funds organized within Canada, whether as federally incorporated companies, provincially incorporated companies, trusts or otherwise, and whether or not they sell their securities in Canada; and it would apply to mutual funds organized outside Canada which sell their securities in Canada. The statute covers both mutual funds which sell their securities exclusively within one province and those which sell their securities in more than one province. The statute imposes, among other things, capital requirements including limitations on borrowing and rules concerning redemption; it prohibits a secondary market; it regulates management fees and sales charges; it stipulates other features of the managerial and distribution arrangements; it imposes custodial requirements for valuable assets; and it makes provision for audit, surveillance and a catalogue of remedies for breaches of the Act. The scheme therefore involves not only the regulation of the distribution of mutual fund securities, but also continuing regulation of the funds' internal operations.

It is natural to inquire whether the federal Parliament has the constitutional power to enact a statute regulating the mutual fund industry in such detail. The purpose of this appendix is to state the arguments which support the conclusion that the federal Parliament does have the power. Crucial to an assessment of the strength of the constitutional arguments is an understanding of the policy reasons which suggest that comprehensive regulation of all the elements of the mutual fund industry, in order to be effective, should be federal; an attempt will be made to explain these first. Then each of the heads of federal constitutional power which could be relied upon will be examined in turn.

The policy arguments in favour of federal regulation

(a) Impact on the national economy:

Mutual funds are an important vehicle for the investment of part of the national savings. If mutual fund regulation is successful in protecting the investor and in gaining and sustaining his confidence, while also encouraging the development of a strong mutual fund industry, then the investor will presumably increase his participation in the securities market through the vehicle of mutual funds. The securities market, and the capital market generally, is national in scope with money and securities flowing freely from one province to another. The economic effects of the flow of savings into these markets are national in their scope, and the regulation of the funds should be treated as a matter requiring one national policy, not a number of provincial policies, even if those policies are uniform at some time.

(b) National and international scope of industry and of individual funds:

The mutual fund industry itself is national and international. It operates throughout the country and elsewhere. Each of the major funds sells its securities in more than one province,

and some of the funds sell in foreign countries as well. Most funds invest at least a portion of the proceeds of their Canadian sales in United States' stocks, and some funds invest almost exclusively in foreign stocks. The organization of a typical mutual fund complex is not readily susceptible to local regulation. The fund itself, which may be either a corporation or a trust, is normally associated with separate management and distribution companies. These components will not necessarily be incorporated in the same jurisdiction, and their offices will not necessarily be located in the one province. It is the complex as a whole which must be regulated, of course, and since it does not observe provincial boundaries it is desirable that the regulator should not have to either.

No province has yet enacted a statute subjecting mutual funds to comprehensive regulation. The funds are however subject to some provincial regulation, because a fund selling shares within a particular province comes within the jurisdiction of the securities commission of that province. Most of the provincial commissions have agreed upon a number of "national policy statements" which set out requirements which will be demanded by each provincial commission from any mutual fund selling its shares in the province. These "national policies" demonstrate that there are pressures towards uniformity of regulation. Sufficient of the provincial commissions subscribe to these "national" policies to make them effective in practice, but it is worth noting that not all provincial commissions do subscribe to them.

For a scheme of regulation as detailed and comprehensive as that now proposed, provincial enactment and administration (assuming that it would be constitutional) would create grave difficulties for national organizations. Many requirements simply have to be uniform. A national organization could not comply with inconsistent investment requirements, for example, or inconsistent rules as to borrowing or management fees. The appointment of a receiver, and other remedies to protect investors, cannot easily be accomplished on a provincial basis. Even where provincial requirements were uniform, where administrative consents or waivers are required (as they are by many provisions of the proposed scheme) the existence of several administrators is at least a nuisance and at worst would cause disastrous delays. What is needed is one regulatory scheme, and one administrator, for the entire industry.

(c) Uniformity of ethical standards:

Standards of honesty, fair dealing and openness should not differ from one part of Canada to another. Yet, if the regulation of mutual funds were left to the provinces, the amount of regulation would vary from one part of the country to another. It is unlikely that each province would enact uniform legislation. Even where provincial statutes were the same or similar it is unlikely that each province would administer its statute in the same way; on the contrary, the number and quality of each administrator's staff would vary from province to province, and so would the administrative procedures and policies of each administrator. It is even possible that some provinces would choose not to regulate mutual funds at all, or not to do so with any vigour, in order to encourage a local industry. Needless to say, most mutual funds would want access to the wealthiest provinces and would therefore have to comply with the requirements of those provinces. But those provinces, while undoubtedly able to regulate the distribution arrangements within their own boundaries, might if challenged be held constitutionally unable to regulate investment, borrowing and other management functions if the functions were performed outside their own boundaries. Even with regard to distribution arrangements, it would be possible for marginal funds which were willing to limit their financial potential to concentrate their activities in provinces where regulation was least effective. It might even be possible for a mutual fund operating in a lax province to

work out a procedure for selling to the residents of Ontario (for example) without having to comply with Ontario law; the cases on securities regulation (discussed below) indicate that direct dealings between the fund and the Ontario resident would attract Ontario regulation, but the courts have not yet had to rule on any more sophisticated procedure such as one involving the use of a foreign intermediary. Whether or not interprovincial selling from lax provinces becomes a reality, the point is that all the residents of Canada should be entitled to receive the same quality of protection from unscrupulous mutual fund operators.

Equality of treatment is also important from the point of view of the industry itself. If some funds were less adequately regulated than others, those funds might have a competitive advantage over the others, especially if they could gain access to the wealthy markets. This is clearly unfair to those funds which are subjected to adequate regulation; and it would create pressures on even the most honest and reputable funds to take advantage of any available haven.

(d) International comity:

There are some international aspects of the regulation of mutual funds. Perhaps most obvious is the desirability of negotiating with the Securities and Exchange Commission of the United States in order to arrive at arrangements satisfactory to both Canada and the United States for mutual funds selling in both countries (Mutual Fund Report, s.16.70). It may also become desirable to enter into arrangements with other countries as well. In fact, new arrangements for a Canadian-based fund selling in Germany have recently been entered into with the German authorities. Such international arrangements are clearly a matter of federal concern. The federal government has participated in the discussions which led to the publication of the Organization for Economic Cooperation and Development's "Standard Rules for the Operation of Institutions for Collective Investment in Securities" (1972), which sets out proposed rules for mutual fund regulation.

The good name of Canada is also in issue. If Canada allowed some provinces to become havens for mutual fund complexes selling abroad, and seeking to avoid regulation, it would become the object of justifiable grievances by a foreign country in whose territory such funds were selling their shares. Canada has in the past permitted mutual fund complexes, operating out of Canada, to sell their securities in other countries. The notorious example is I.O.S., a complex managed by a company incorporated under Canadian federal law with its head office in New Brunswick, which distributed shares in mutual funds incorporated in various parts of the world including (in the case of The Fund of Funds) Ontario; the affairs of I.O.S. (which are not yet in order) became an international financial scandal, and they have been the subject of complaints against Canada from other countries. This underlines the fact that considerations of international comity provide a federal interest in mutual fund regulation.

(e) Defects in provincial power:

It has already been mentioned that the provinces, as part of their securities regulation, exercise some control over mutual funds selling shares in the province. The constitutional basis for this control would be the provincial jurisdiction over "property and civil rights in the province": B.N.A. Act, s. 92(13). Of course, if the federal Parliament validly enacted an inconsistent regime of regulation, the federal regulation would be paramount.

However, even in the absence of federal regulation, provincial regulation would not be wholly effective, at least to execute a scheme as comprehensive as that now proposed. The

most serious defect in provincial power is of course its territorial limitation which for the reasons advanced earlier precludes satisfactory regulation of an industry which is nation-wide and of particular funds which are organized in more than one jurisdiction or which operate in more than one province. Even within the territory of any one province there are defects in provincial power. There are cases which decide that corporations incorporated under federal law cannot constitutionally be subjected to provincial laws to the extent that those laws impair the essential attributes of (federal) corporate status; and that laws restricting the capacity of a federal corporation to raise capital do impair the essential attributes of its corporate status (*Lukey* v. *Ruthenian Farm Elevators Co.* [1924] S.C.R. 56; *A.-G. Can.* v. *A.-G. Man.* [1929] A.C. 260). The mutual fund regulation envisaged by the proposed statute involves laws of this kind, and therefore mutual funds which chose to organize themselves as federal corporations might be able to escape much provincial regulation. In fact, most of the big mutual funds are organized as federal corporations (although for taxation reasons the trust has become a favoured vehicle for funds organized very recently).

Another gap in provincial power is the regulation of interprovincial or international trade and commerce, which is a matter exclusively within federal jurisdiction. In other words, the provincial power over ''property and civil rights in the province'' does not extend to interprovincial and international trade and commerce. This rule led to the invalidity of the Manitoba egg marketing scheme, which was held unconstitutional *even within Manitoba* on the ground that the scheme had the effect of restricting ''the free flow of trade between Provinces as such'' (*A.-G. Man.* v. *Manitoba Egg and Poultry Association* (1971) 19 D.L.R. (3d) 169, at 179 per Martland J.). It is possible that the marketing cases would be held irrelevant to the regulation of mutual funds. The Manitoba Court of Appeal has decided that the province of Manitoba has the constitutional power to regulate, as part of its scheme of securities regulation, a sale of securities from a broker in Ontario by telephone and mail to a Manitoba resident (*R.* v. *W. McKenzie Securities Ltd.* (1966) 56 D.L.R. (2d) 56). The Supreme Court of Canada has not yet ruled on the question (having left it undecided in *Gregory* & *Co.* v. *Quebec Securities Commn.* [1961] S.C.R. 584). If the Supreme Court does decide to follow the *McKenzie* decision, that would still leave open the possibility that devices involving foreign intermediaries would succeed in escaping provincial regulation. And, more importantly, the *McKenzie* case does not suggest that a sale of a mutual fund security to a Manitoba resident is sufficient to enable the Manitoba legislature to regulate matters which occur outside Manitoba and which have an impact on the residents of other provinces in which the fund sells its securities, e.g., the audit of the fund's accounts, the investment of the fund's assets, borrowing by the fund, or management fees.

The facts that provincial power (1) is confined to the territory of the province, (2) does not extend to the raising of capital and other essential attributes of federally incorporated companies, and (3) does not include interprovincial or international trade and commerce, are serious difficulties in the way of provincial regulation of the mutual fund industry. They have not prevented the provinces from filling the void and undertaking very effectively an important degree of regulation. But the more pervasive regulatory pattern here proposed could not be imposed by the provinces.

The next three sections of this Appendix will deal with the heads of federal power which might be invoked in support of federal regulation of the mutual fund complex, namely, the ''peace, order, and good government'' power, the ''trade and commerce'' power, and the ''criminal law'' power.

The "peace, order, and good government" (pogg) power

The opening words of s. 91 of the B.N.A. Act give to the federal Parliament power "to make laws for the peace, order, and good government of Canada, in relation to all matters not coming within the classes of subjects by this Act assigned exclusively to the legislatures of the provinces". This power, which will be described hereinafter as the pogg power, is sometimes described as the "general" power or (less accurately) the "residuary" power. The vagueness and generality of the phrase "peace, order, and good government" have led to a good deal of litigation as to its meaning.

In *Russell* v. *The Queen* (1882) 7 App. Cas. 829 the Privy Council held that the pogg power was capable of sustaining the Canada Temperance Act, a federal statute which regulated the sale and consumption of liquor on a local option basis. This case suggested a wide scope for the pogg power, but in a later series of cases the Privy Council narrowed the scope of the power until it seemed to be available as a regulatory power only in emergencies such as war. Their lordships held that the power could not support an insurance statute (*A.-G. Can* v. *A.-G. Alta.* [1916] 1 A.C. 588), a combines and fair prices statute (*Board of Commerce* case [1922] 1 A.C. 191), a labour relations statute (*Toronto Electric Commissioners* v. *Snider* [1925] A.C. 396), an unemployment insurance statute (*A.-G. Can.* v. *A.-G. Ont.* [1937] A.C. 355), minimum wage and hours of labour statutes (*A.-G. Can.* v. *A.-G. Ont.* [1937] A.C. 326) and a natural products marketing statute (*A.-G. B.C.* v. *A.-G. Can.* [1937] A.C. 377).

Even the depression of the 1930s was deemed by the Privy Council of this period to be an insufficient "emergency" to enable the federal Parliament to use the pogg power as a basis of economic regulation. Only the first world war was deemed sufficient (*Fort Frances Pulp & Power Co. Ltd.* v. *Manitoba Free Press Co. Ltd.* [1923] A.C. 695), though not the economic dislocation which followed it (*Board of Commerce* case [1922] 1 A.C. 191). The old decision in *Russell* v. *The Queen,* upholding the Canada Temperance Act, which could not plausibly be explained as a response to a national emergency, was never actually overruled during this period, although it could not be reconciled with the new "emergency" doctrine. In *A.-G. Ont.* v. *Canada Temperance Federation* [1946] A.C. 193 a new attack was made upon the Canada Temperance Act, and the authority of *Russell* was challenged. The Privy Council upheld the Act, and reaffirmed the authority of *Russell.* And, in an abrupt and unexplained reversal, the Privy Council rejected the emergency doctrine as "too narrowly expressed" and substituted a new, and much wider, definition of pogg:

> In their Lordships' opinion, the true test must be found in the real subject matter of the legislation: if it is such that it goes beyond local or provincial concern or interests and must from its inherent nature be the concern of the Dominion as a whole ([1946] A.C. 193 at 205).

The Privy Council decisions which limited the pogg power to "emergencies" were rendered during a period when the Privy Council was, if not hostile to federal power, at least highly restrictive of it. We shall see in the next section of this Appendix that the trade and commerce power was also severely attenuated at this time. Since the abolition of appeals to the Privy Council in 1949 the trend of the decisions has been reversed. Since it became the final court of appeal for Canada the Supreme Court of Canada has been sympathetic to assertions of federal power; indeed, my search indicates that there has been no decision of the Supreme Court of Canada in which a federal statute has been held unconstitutional

on any ground whatever since appeals were abolished. In the few pogg cases which have arisen since 1949 the Canadian courts have been applying the new liberal definition of pogg which the Privy Council enunciated in *Canada Temperance* in 1946—just before appeals ended.

The *Canada Temperance* definition is so vaguely expressed that it is impossible to be certain about its scope, especially as the cases applying the old emergency doctrine have never been expressly overruled. The cases indicate, however, that the Canadian courts are willing to take an expansive view of the new definition. The pogg power has been used to sustain federal jurisdiction over aeronautics (*Johannesson* v. *West St. Paul* [1952] 1 S.C.R. 292), atomic energy (*Pronto Uranium Mines* v. *Ont. Labour Relations Board* [1956] O.R. 862) and the national capital region (*Munro* v. *National Capital Commn.* [1966] S.C.R. 663).

Once a statute is characterized as in relation to pogg (or any other head of federal power) it is no objection to its validity that it regulates contracts or property or other subject matters which would otherwise be within provincial jurisdiction. The zoning of land and the expropriation of land are matters of ''property and civil rights in the province'' which would normally be within exclusive provincial jurisdiction, but a federal statute in relation to aeronautics (*Johannesson*) or the national capital region (*Munro*) may validly impose zoning requirements or expropriate land, because aeronautics and the national capital region are matters within the peace, order, and good government of Canada. The regulation of labour relations was held in *Toronto Electric Commissioners* v. *Snider* [1925] A.C. 396 to be a matter of ''property and civil rights in the province'' and therefore within exclusive provincial jurisdiction, but the federal Parliament may regulate labour relations in industries which are within federal jurisdiction such as navigation and shipping, interprovincial railways, telephone and telegraph communications (*Industrial Relations and Disputes Investigation Act Reference* [1955] S.C.R. 529); this doctrine was applied to workers involved in the production of atomic energy in *Pronto Uranium Mines* v. *Ont. Labour Relations Board* [1956] O.R. 862 on the ground that atomic energy was a matter within the peace, order, and good government of Canada. So powerful is this doctrine that some decisions of the Supreme Court of Canada not only confer federal power to regulate contracts and property in matters within federal jurisdiction, but also hold that provincial power is completely excluded. This was the holding in the pogg case of *Johannesson,* which has already been mentioned; and a similar exclusion of provincial power to regulate contracts or property was decided upon in *Campbell-Bennett Ltd.* v. *Comstock Midwestern Ltd.* [1954] S.C.R. 207 and *Commission du Salaire Minimum* v. *Bell Telephone Co.* [1966] S.C.R. 767. For myself, I consider that these decisions are unnecessarily generous to federal power; and that it would be sufficient to hold that federal and provincial power is concurrent (as seems to have been decided by O'Driscoll J. in *R.* v. *Lake Ontario Cement Ltd.* [1973] 2 O.R. 247). However the decisions indicate how far the Supreme Court of Canada has travelled in the opposite direction from the Privy Council. In any event, one can assert with confidence that, if the regulation of mutual funds is held to be a matter within pogg (or trade and commerce), then federal power will extend to the kind of detailed regulation of contracts, trusts, property rights and other matters which would normally be within ''property and civil rights'' which is contemplated by the proposed mutual fund statute.

Is the regulation of mutual funds within pogg? Are mutual funds analogous in some sense to liquor, aeronautics, atomic energy and the national capital? The common element in these diverse subjects is that (in terms of the *Canada Temperance* definition) each ''goes beyond local or provincial concern or interests and must from its inherent nature be the

concern of the Dominion as a whole.'' Can the same be said of the mutual fund industry? The answer, it is submitted, is yes. The impact of the mutual funds on the national economy, the national and international scope of the industry and of individual funds, the need for uniformity of ethical standards, considerations of international comity, defects in provincial power—in other words, all the policy reasons which were described earlier as supporting federal intervention—combine to demonstrate that the mutual fund industry does meet the *Canada Temperance* test, and is therefore within the federal Parliament's pogg power.

The ''trade and commerce'' power

(a) Interprovincial and international trade and commerce:

The federal Parliament, under s. 91(2) of the B.N.A. Act, has power to enact laws in relation to ''the regulation of trade and commerce''. In using this general language our founding fathers deliberately left out the restrictive words of the commerce clause of the constitution of the United States (Art. 1, s. 8(3)), which conferred power ''to regulate commerce with foreign nations, and among the several States . . .''. And yet the Canadian trade and commerce power has so far proved to be a far more limited one than the U.S. commerce power. The Privy Council early construed the Canadian trade and commerce power as not extending to intraprovincial trade and commerce. That was a matter of ''property and civil rights in the province'' within provincial jurisdiction under s. 92(13), and possibly also a matter of a ''merely local or private nature'' within provincial jurisdiction under s. 92(16).

In a series of marketing cases before the abolition of appeals to the Privy Council the Privy Council and Supreme Court of Canada applied this doctrine in an inflexible manner which virtually destroyed the effective federal power to regulate marketing. In *The King* v. *Eastern Terminal Elevator Co.* [1925] S.C.R. 434 the Supreme Court of Canada struck down a federal statute which regulated the grain trade. As is common knowledge (and was recognized by the judges in the case), very little of Canada's grain is actually consumed in the province of production, and the great bulk of it is exported. Nevertheless, the federal statute had to fasten onto some local operations, and in particular to license and regulate grain elevators, in order to make the scheme effective. The court held that the regulation of local works such as elevators made the scheme invalid. Similarly, in *A.-G. B.C.* v. *A.-G. Can.* [1937] A.C. 377, a statute was held invalid which provided for the establishment of marketing schemes for natural products whose principal market was outside the province of production, or which had a partly export market. The Privy Council held the statute invalid because it included within its purview some transactions which could be completed within the province.

The reversal of the Privy Council's anti-federal tendency, which we noticed in the pogg cases, is also apparent in the trade and commerce cases. A new attitude was discernible in the *Ontario Farm Products Reference* [1957] S.C.R. 198, a case concerning a provincial statute in which four judges indicated by implication that federal power would extend to some transactions which were completed within a province. In *R.* v. *Klassen* (1959) 20 D.L.R. (2d) 406 the Manitoba Court of Appeal held that a federal marketing statute, designed to regulate the interprovincial and export trade in grain, could as an incident of that regulation impose a quota system on a local feed mill the operations of which were exclusively intraprovincial. This decision appears to be inconsistent with the *Eastern Terminal Elevator* and *Natural Products Marketing* cases. And yet the Supreme Court of Canada denied leave to appeal. The new development suggested by the refusal of leave to appeal in *Klassen*

was confirmed in *Caloil Inc.* v. *A.-G. Can.* [1971] S.C.R. 543, when the Supreme Court of Canada unanimously upheld a federal prohibition on the transportation or sale of imported oil west of the Ottawa valley. The purpose was to protect the domestic industry from the then cheaper imported product. This prohibition clearly caught many transactions which would otherwise have been completed within a province. Yet it was upheld as ''an incident in the administration of an extraprovincial marketing scheme''.

There are a number of differences between the market in securities and the market in natural products or manufactured commodities; and yet from a constitutional point of view the similarities are more important than the differences. One difference is that securities are intangible whereas commodities are tangible, but it is hard to see why this should be of constitutional significance. Another difference is that in the securities market there is no flow of goods from a province of production (or manufacture or import) to another province (or country) of consumption; it was the existence of this interprovincial or international flow which enabled the courts in *Klassen* and *Caloil* to uphold the regulation of intraprovincial transactions: such regulation was incidental to the ultimate objective of regulating the interprovincial flow. However, although the securities market is quite different from that in grain or oil, they have one crucial feature in common. The mutual fund industry is, as has already been explained, one of the routes by which savings find their way into the capital market. That market is national and international with capital flowing from one jurisdiction to another. Thus the regulation of the mutual fund industry has an overriding interprovincial element analogous to that recognized in *Klassen* and *Caloil.* The many intraprovincial elements which have to be swept into the scheme of regulation are subordinate to the ultimate objective of regulating one important component of an interprovincial and international capital market (cf. P. T. Banwell, ''Proposals for a National Securities Commission'' (1969) 1 *Queens Intramural* L.J. 3 at 9). On this basis, the regulation of the mutual fund industry can and should be held to be within federal competence as in relation to interprovincial and international trade and commerce.

(b) General trade and commerce:

The trade and commerce power, as a support for federal regulation of the mutual fund industry, may be approached from another point of view, one which emphasizes the general or national character of the regulation which the power contemplates. The nineteenth century cases which held that the federal trade and commerce power extended to interprovincial and international trade and commerce also included another category, namely, ''general regulation of trade affecting the whole dominion''. These early cases indicated that this ''general'' trade and commerce power would authorize the regulation of trade and commerce which was ''national in its scope'' or which was ''a matter of general interest and importance throughout Canada''. Just what is included in these phrases is by no means clear. The Privy Council held in 1916 that the general trade and commerce power would not authorize federal regulation of insurance *(A.-G. Can.* v. *A.-G. Alta.* [1916]1 A.C. 588). In 1922 the Privy Council held that the power would not authorize the control of profiteering after the first world war *(Board of Commerce* case [1922] 1 A.C. 191). And in 1925 the Privy Council held that the power would not authorize federal labour legislation *(Toronto Electric Commissioners* v. *Snider* [1925] A.C. 396). In each of these cases the federal statute was held to be in relation to property and civil rights in the province, a provincial subject matter.

While these cases rejected the use of the trade and commerce power to regulate transactions which were not, regarded individually, interprovincial or international, they did so

in vague language which did not preclude the possibility of some application for the so-called "general" category of trade and commerce. And one line of authority has upheld such an application. In *John Deere Plow Co.* v. *Wharton* [1915] A.C. 330 the Privy Council held that the federal Parliament had the power to incorporate companies with other than provincial objects. Their lordships placed this power under peace, order, and good government, not trade and commerce. Did the Parliament also have the power to prescribe how the companies' objects were to be attained, for example, the power to sue and be sued, to contract, to hold property, etc.? Their lordships answered yes, and held that this latter power was derived from the trade and commerce power.

> But they (their lordships) think that the power to regulate trade and commerce at all events enables the Parliament of Canada to prescribe to what extent the powers of companies the objects of which extend to the entire Dominion should be exercisable, and what limitations should be placed on such powers. For if it be established that the Dominion Parliament can create such companies, then it becomes a question of general interest throughout the Dominion in what fashion they should be permitted to trade ([1915] A.C. 330, at 340).

The *John Deere* case therefore asserted a power to regulate trade and commerce where it was neither interprovincial nor international, but was "a question of general interest throughout the Dominion". In *A.-G. Ont.* v. *A.-G. Can.* [1937] A.C. 405 the Privy Council stated that the power to create and regulate trade marks lay with the federal Parliament under the trade and commerce power. The actual decision in that case was to uphold a federal statute which created a "national" trade mark. This was a valid exercise of the trade and commerce power, although the use of the mark was to be quite general (as a quality indication) and was not to be confined to interprovincial or international trade. In *Reference re Alberta Statutes* [1938] S.C.R. 100, at 116-121 Duff C. J. and Davis J. gave as their reason for striking down some of Alberta's social credit legislation that the creation of a new system of credit to be used as a means of exchange was a matter within the federal trade and commerce power. In the recently reported case of *Vapor Canada Ltd.* v. *MacDonald* (1972) 33 D.L.R. (3d) 434 (leave to appeal to the Supreme Court of Canada granted on December 11, 1972) the Federal Court of Appeal decided that the general trade and commerce power authorized those provisions of the federal Trade Marks Act which proscribe certain unfair business practices. The court characterized the Act as "a law of general application regulating standards of business conduct in Canada" (p. 449), and concluded that such a law was one "for the general regulation of trade affecting the whole country" (p. 447).

Obviously there is a "general" trade and commerce power which will allow the federal Parliament to regulate trade and commerce which is not primarily interprovincial or international, but which is "of general interest throughout the Dominion". Whether it would sustain the proposed statute is not completely clear having regard to the *Insurance* case, the *Board of Commerce* case and *Snider*. But it is likely that the Supreme Court of Canada would be reluctant to use those cases today as precedents to invalidate a statute in a different field of law. Those decisions were rendered in the period when the Privy Council was hostile to federal power. The *Board of Commerce* and *Snider* cases were important in reducing the peace, order, and good government power to an "emergency" doctrine, and in reducing the trade and commerce power to a power merely ancillary to other federal powers. Both of these doctrines are now discredited, and the authority of the decisions rendered during this period must be treated as at least doubtful. The federal Parliament has in fact reentered

the areas of regulation apparently closed to it by these decisions; and the courts have been willing to sustain more limited regulation of insurance, combinations and labour under other federal powers (*A.G. Ont.* v. *Policy Holders of Wentworth Insurance Co.* [1969] S.C.R. 779 (insurance); *P.A.T.A.* v. *A.-G. Can.* [1931] A.C. 310 (combinations); *Industrial Relations and Disputes Investigation Act Reference* [1955] S.C.R. 529 (labour).

Another reason to be wary of the Privy Council decisions which so limited the trade and commerce power is that the Privy Council usually refused to examine the kind of data which might have demonstrated the nation-wide implications of the problems dealt with by the legislation which was in issue in those cases. Their lordships thereby almost precluded themselves from characterizing problems as national in their scope. Instead they tended to characterize each statute as an attempt to regulate a lot of individual transactions most of which occurred entirely within a province. Viewed from this perspective it is not surprising that each statute was held to be solely in relation to property and civil rights in the province. The Supreme Court of Canada has ever since the abolition of appeals to the Privy Council in 1949 made a greater effort to understand the reasons which lie behind the statutes which come before it for decision, and as a result it has tended to uphold the validity of federal statutes. In *Caloil Inc.* v. *A.-G. Can.* [1971] S.C.R. 543, a case which has already been mentioned, the Supreme Court of Canada upheld federal restraints on the sale of imported oil The objective of the restraints was to protect the domestic oil industry. Pigeon J., who wrote the principal opinion, recognized (at p. 551) that ''the development and utilization of Canadian oil resources'' was a matter which had a federal aspect, and that restrictions on the sale of imports in one part of Canada in order to reserve the market for domestic products was a legitimate federal purpose. The Privy Council would probably have been unwilling to view the facts in this broad light. Indeed, in one of the last Canadian cases which it decided, namely, the *Margarine Reference* [1951] A.C. 179, the Privy Council refused to view analogous facts—prohibitions on margarine to protect the dairy industry—as a national problem justifying federal regulation. The legislation in issue in *Caloil* was not closely analogous to mutual fund regulation. What *Caloil* indicates, however, is that the Supreme Court of Canada is prepared to characterize legislation in a broader and more realistic way than the ''worm's eye view'' habitually taken by the Privy Council.

The Privy Council's rejection of several assertions of federal jurisdiction over the insurance industry is a precedent which is unfavourable to the constitutionality of federal mutual fund regulation. The Privy Council's decisions were premised on an early classification of insurance regulation as the regulation of the terms of ''the contracts of a particular business or trade'' (*Citizens' Insurance Co.* v. *Parsons* (1881) 7 App. Cas. 96) or as ''the regulation by a licensing system of a particular trade'' (*A.-G. Can.* v. *A.-G. Alta.* [1916] 1 A.C. 588). Each subsequent attempt at federal regulation was condemned as a colourable version of what had previously been held invalid *(A.-G. Ont.* v. *Reciprocal Insurers* [1924] A.C. 328; *Re Insurance Act of Canada* [1932] A.C. 41; *Re s. 16 of the Special War Revenue Act* [1942] S.C.R. 429, leave to appeal to P.C. refused, [1943] 4 D.L.R. 657). And yet in the *Wentworth Insurance* case [1969] S.C.R. 779 the Supreme Court of Canada upheld provisions in the federal Winding-Up Act which regulated the distribution on the winding-up of an insurance company of the securities which the company was required under provincial law to deposit with the provincial government. The federal provisions, which were applicable only to insurance companies, were upheld as relating to ''insolvency'', a federal head of power under s. 91 (21). When it is recalled that the Privy Council had rejected as ''colourable'' a ''licensing'' law, a ''criminal'' law, an ''immigration'' law, an ''aliens'' law, and a ''taxation law'', the Supreme Court's decision to uphold an ''insolvency'' law directed solely

at insurance companies is a departure from Privy Council doctrine, as Hall J.'s dissenting judgment clearly demonstrates. The *Wentworth Insurance* case is of no direct relevance to the regulation of mutual funds. Its importance lies in its demonstration that the Supreme Court of Canada makes its own decisions as to the proper characterization of a statute. The fact that the Privy Council would have decided otherwise is not necessarily decisive. If the Supreme Court of Canada can be persuaded to characterize a mutual fund statute as relating to general trade and commerce (or pogg or criminal law) it will not be deflected from its decision by estimates of how the Privy Council might have made the characterization.

There is an important difference between the insurance and mutual fund industries. Although they are in one sense in competition for the savings dollar, they do offer a very different product. The insurance industry is primarily concerned with selling insurance. Under an insurance policy an insurer indemnifies the insured against certain specified risks. The risks insured against, and the other terms and conditions of the arrangement, are defined in the policy; the policy is of course a contract. The mutual fund industry, by contrast, is selling a form of investment. Each share (or unit) of a mutual fund is a proportionate interest in a diversified portfolio of securities; the share provides to its purchaser nothing more nor less than a conduit to the capital market. The mutual fund does undertake the obligation to redeem the share upon demand, but unlike the obligations of an insurer, the measure of that obligation will depend upon the performance of the mutual fund's portfolio of securities. (There are some recently developed forms of insurance—variable annuity and variable life—in which the insurer's obligations vary with the performance of a pool of investments. But this is not the traditional kind of insurance policy, and it was entirely unknown when the Privy Council rendered its decisions in the insurance cases.) It is therefore understandable that the Privy Council looked at the insurance business as a matter of contracts ("civil rights in the province") rather than as a matter of "general regulation of trade affecting the whole dominion"; indeed this viewpoint was not a serious distortion of the actual situation; the channelling of funds to the capital market is just a side effect of an insurance contract, whereas it is the essential purpose of a sale of mutual fund securities. To regard the sale or distribution function (carried out by the distribution company) as something which can be viewed in isolation from the investment function (carried out by the management company) would be a serious misreading of the nature of a mutual fund. The only realistic way to view the mutual fund industry is as the controller of a substantial flow of savings from private investors into a national and international capital market. In constitutional language, the regulation of the industry is a regulation of trade and commerce which is "national in its scope", or "a matter of general interest and importance throughout Canada", and as such is within the federal Parliament's power to regulate "general" trade and commerce.

The "criminal law" power

The federal Parliament, under s. 91(27) of the B.N.A. Act, has the power to enact "criminal law". The proposed mutual fund statute does not look like a criminal law, and it is quite likely that the Supreme Court of Canada would hold it not to be a criminal law. But, perhaps in order to compensate for the Privy Council's narrow interpretations of the pogg and trade and commerce powers, the courts have tended to take a broad view of the criminal law power. It is therefore a possible source of power which should not be ignored. The aspect of the statute which would need to be emphasized is the fact that most of its provisions are addressed to the protection of the investor; this is the kind of purpose which, it has been held, may validly be pursued by a criminal law.

The Criminal Code now includes as offences the making, circulating or publishing of a false prospectus; these provisions were recently considered by the Supreme Court of Canada and were held or assumed to be valid by every member of the nine-man bench *(Smith* v. *The Queen* [1960] S.C.R 776). And in cases considering provincial securities legislation there are dicta which emphasize that the purpose of securities legislation is the prevention of fraud; these dicta were not addressed to the question of federal power (which was not in issue), but they are suggestive of federal power to regulate the trade in securities under the criminal law power *(Gregory* & *Co.* v. *Quebec Securities Commn.* [1961] S.C.R. 584, at 590; *R.* v. *W. McKenzie Securities Ltd.* (1966) 56 D.L.R. (2d) 56, at 62). Various kinds of economic regulation having as their main purpose the protection of consumers have been upheld as criminal law: anti-combination legislation *(P.A.T.A.* v. *A.-G. Can.* [1931] A.C. 310), anti-price-cutting legislation *(A.-G. B.C.* v. *A.-G. Can.* [1937] A.C. 368), and anti-resale-price-maintenance legislation *(R.* v. *Campbell* (1965) 58 D.L.R. (2d) 673). In the last case the opinions in the Ontario Court of Appeal ((1964) 46 D.L.R. (2d) 83) stated the criminal law power very broadly, and the Supreme Court of Canada affirmed the Court of Appeal without comment. The book on *Canadian Constitutional Law* by Bora Laskin (now Chief Justice of the Supreme Court of Canada) asserts that "resort to the criminal law power to proscribe undesirable commercial practices is today as characteristic of its exercise as has been resort thereto to curb violence or immoral conduct" (3d ed. rev., 1969, at 851; 4th ed., 1973, at 824).

The proposed statute differs from the statutes hitherto held to be "criminal" in that it sets up a fairly complex scheme of regulation, including many positive requirements (as opposed to prohibitions), and it gives discretionary regulatory power to an administrator. Legislation "to curb violence or immoral conduct" is rarely complex, and that is the kind of legislation which most people tend to associate with criminal law. But, in order "to proscribe undesirable commercial practices", simple prohibitions, such as those of the Criminal Code, are often insufficient. In the *P.A.T.A.* case itself, where the Privy Council gave its definition of a criminal law as an "act prohibited with penal consequences", the Privy Council upheld as criminal law anti-combination legislation which granted extensive investigatory powers to a registrar and commissioners. On the other hand, however, in *A.-G. Ont.* v. *Reciprocal Insurers* [1924] A.C. 328, the criminal law power was rejected as a basis for federal regulation of the insurance industry. There is no decided case which upholds as criminal law a regulatory scheme as complex as that which is proposed for the mutual fund industry. It is arguable, nevertheless, that the essential aim of the proposed statute is to proscribe undesirable commercial practices and to subject them to criminal sanctions, and that the proposed statute is therefore a "criminal law" in the constitutional sense of that term.

If the court did characterize the positive regulatory requirements as well as the prohibitions as part of an entire scheme which was in pith and substance criminal law, then the various remedies proposed by the statute (e.g., rescission, refunds, appointment of receiver, stopping of sales, surveillance, etc.) would probably be upheld as ancillary to the principal "criminal" provisions of the statute. The courts have been willing to characterize as "criminal" quite a wide range of remedies, where those remedies have been ancillary to what was in pith and substance a criminal law, e.g., the closing of a house *(Switzman* v. *Elbling* [1957] S.C.R. 285), the forfeiture or confiscation of property *(Johnson* v. *A.-G. Alta.* [1954] S.C.R. 127, S.C. Can. evenly divided on this point; *Industrial Acceptance Corp.* v. *The Queen* [1953] 2 S.C.R. 273) and the enjoining of undesirable conduct *(A.-G. Ont.* v. *Koynok*

[1941] 1 D.L.R. 548; *Provincial Secretary P.E.I.* v. *Egan* [1941] S.C.R. 396; *Goodyear Tire & Rubber Co. of Canada Ltd.* v. *The Queen* [1956] S.C.R. 303).

Conclusion as to Constitutionality

The conclusion is that there is a very strong case for the proposition that the federal Parliament has the constitutional power to regulate the mutual fund industry under three heads of power:

(1) The ''peace, order, and good government'' power (B.N.A. Act, s. 91):

The impact of the mutual fund industry on the national economy, its impact on the international scene, the national and international organization and operations of the industry and of individual funds, and defects in provincial power, combine to lead to the conclusion that the mutual fund industry ''goes beyond local or provincial concern or interests and must from its inherent nature be the concern of the Dominion as a whole''. As such, the regulation of the industry is a matter within the ''peace, order, and good government'' power of the federal Parliament.

(2) The ''trade and commerce'' power (B.N.A. Act, s. 91(2)):

The mutual fund industry as a conduit for private savings to enter an interprovincial and international capital market is an element of ''interprovincial and international trade and commerce'', and of trade and commerce which is ''national in its scope''. As such, it is within the ''trade and commerce'' power of the federal Parliament.

(3) The ''criminal law'' power (B.N.A. Act, s. 91(27)):

Mutual fund regulation has as a principal objective the protection of the investor from dishonest, unethical, expensive or risky business practices. As a measure designed ''to proscribe undesirable commercial practices'', and matters incidental thereto, mutual fund regulation is within the ''criminal law'' power of the federal Parliament.

The case for federal power is strong under each of the first two heads regarded in isolation, and less strong under the third. The cumulative effect of the arguments under all three heads makes a very strong case indeed.

Notes

Notes

Notes